DOCKET

No. 88-1480-CFX
Status: GRANTED

Title: Bob Reves, et al., Petitioners
v.
Arthur Young & Co.

Docketed:
March 2, 1989

Court: United States Court of Appeals
for the Eighth Circuit

Counsel for petitioner: McCambridge,John R.

Counsel for respondent: Matson,John

Entry	Date	Note	Proceedings and Orders
1	Mar 2 1989	G	Petition for writ of certiorari filed.
2	Mar 31 1989	X	Brief of respondent Arthur Young & Co. in opposition filed.
3	Apr 5 1989		DISTRIBUTED. April 21, 1989
4	Apr 20 1989	X	Reply brief of petitioners Bob Reves, et al. filed.
5	Apr 24 1989	P	The Solicitor General is invited to file a brief in this case expressing the views of the United States.
9	May 20 1989		Brief amicus curiae of United States filed.
6	May 23 1989		REDISTRIBUTED. June 8, 1989
7	May 24 1989	X	Brief of respondent in response to brief of United States, et al. as amici curiae filed.
8	Jun 12 1989		Petition GRANTED.
			**********
15	Jul 26 1989		Brief amicus curiae of Arkansas Securities Department filed.
10	Jul 27 1989		Brief amicus curiae of SEC filed.
11	Jul 27 1989		Joint appendix filed.
12	Jul 27 1989		Brief of petitioners Bob Reves, et al. filed.
16	Jul 27 1989		Brief amicus curiae of North American Securities Administrators Assn., Inc. filed.
14	Aug 4 1989		Order extending time to file brief of respondent on the merits until September 16, 1989.
19	Aug 4 1989	G	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
17	Aug 25 1989		Record filed.
		*	Certified copy of original record and proceedings, 3 boxes, received.
18	Sep 16 1989		Brief of respondent Arthur Young & Co. filed.
20	Sep 25 1989		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
21	Sep 26 1989		SET FOR ARGUMENT MONDAY, NOVEMBER 27, 1989. (3RD CASE)
22	Sep 29 1989		CIRCULATED.
23	Oct 14 1989	X	Reply brief of petitioners Bob Reves, et al. filed.
24	Nov 7 1989		Record filed.
		*	Certified copy of original record, 55 volumes, 10 boxes,received.
25	Nov 27 1989		ARGUED.

PETITION FOR WRIT OF CERTIORARI

88-1480

Supreme Court, U.S.
FILED
MAR 2 1989
JOSEPH F. SPANIOL, JR.
CLERK

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, As Representatives of a Class of Note Holders,

Petitioners,

v.

ARTHUR YOUNG & CO.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

GARY M. ELDEN
(Counsel of Record)
JOHN R. MCCAMBRIDGE
JAY R. HOFFMAN
GRIPPO & ELDEN
Attorneys for Petitioners
20 South Clark Street
Chicago, Illinois 60603
(312) 704-7700

QUESTION PRESENTED FOR REVIEW

Did the Eighth Circuit err when it held, in conflict with other courts of appeals, that uninsured demand notes sold to thousands of passive investors are not "securities"?

TABLE OF CONTENTS

	Page
QUESTION PRESENTED FOR REVIEW	i
TABLE OF CONTENTS	iii
TABLE OF AUTHORITIES	v
OPINIONS BELOW	vii
JURISDICTIONAL GROUNDS	vii
STATUTE INVOLVED	vii
STATEMENT OF THE CASE	1
REASONS FOR GRANTING THE WRIT	3
I. INTRODUCTION	3
II. THE COURT SHOULD RESOLVE THE CONFLICT AMONG THE COURTS OF APPEALS AND SPECIFY THE TEST WHICH SHOULD BE USED TO DETERMINE WHETHER A "NOTE" IS A "SECURITY"	3
III. THE EIGHTH CIRCUIT ERRED WHEN IT DECIDED THAT THE CO-OP'S DEMAND NOTES ARE NOT SECURITIES	5
CONCLUSION	8
APPENDIX	A-1
1. ORDER, AND DISSENTING OPINION ON REHEARING, OF COURT OF APPEALS	A-1

		Page
2.	OPINION OF PANEL OF COURT OF APPEALS	A-8
3.	OPINION OF DISTRICT COURT AS TO FEDERAL SECURITIES LAW	A-29
4.	OPINION OF DISTRICT COURT AS TO ARKANSAS SECURITIES LAW	A-32
5.	15 U.S.C. § 78c(a)(10)	A-82

TABLE OF AUTHORITIES

Cases	Page
American Bank & Trust v. Wallace, 702 F.2d 93 (6th Cir. 1983)	4
Briggs v. Sterner, 529 F. Supp. 1155 (S.D. Iowa 1981)	5, 6, 7
C.N.S. Enterprises v. G & G Enterprises, 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975)	4
Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976)	5
Futura Dev. Corp. v. Centex Corp., 761 F.2d 33 (1st Cir.), *cert. denied*, 474 U.S. 850 (1985)	3, 4, 5
Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230 (2d Cir. 1985)	7
Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976)	4, 6
Hunssinger v. Rockford Business Credits, Inc., 745 F.2d 484 (7th Cir. 1984)	3, 5, 6, 7
Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985)	3, 5
Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973)	4
Marine Bank v. Weaver, 455 U.S. 551 (1982)	7
McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975)	4, 5

Page

People v. Walberg, 69 Cal. Rptr. 457 (Dist. Ct. App. 1968) 7

Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972) .. 7

SEC v. Thunderbird Valley, Inc., 356 F. Supp. 184 (D.S.D. 1973) 7

SEC v. W.J. Howey Co., 328 U.S. 293 (1946) ... 1

SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976) 6, 7

Tcherepnin v. Knight, 389 U.S. 332 (1967) 5

Underhill v. Royal, 769 F.2d 1426 (9th Cir. 1985) 4, 6, 7

United States v. Attaway, 211 F. Supp. 682 (W.D. La. 1962) 6

Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974) 4

Zeller v. Bogue Electric Mfg. Co., 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973) ... 6

Statutes

15 U.S.C. § 78c(a)(10) vi

28 U.S.C. § 1254(1) vi

28 U.S.C. § 1331 1

Other Authorities

L. Loss, *Fundamentals of Securities Regulation* (1988) 3

OPINIONS BELOW

The panel opinion of the U.S. Court of Appeals for the Eighth Circuit is reported at 856 F.2d 52, and included in the Appendix at A-8. The dissenting opinion on rehearing is reported at 856 F.2d 55 (Appendix at A-1). The summary judgment opinion of the U.S. District Court for the Western District of Arkansas is reported at 635 F. Supp. 851 (in pertinent part, Appendix at A-32).

JURISDICTIONAL GROUNDS

On September 2, 1988, the Eighth Circuit reversed the judgment of the district court denying Arthur Young & Co.'s motion for judgment notwithstanding the verdict. On December 2, 1988, a majority of the court of appeals denied the petition for rehearing en banc. This Court has jurisdiction to review the judgment below by writ of certiorari pursuant to 28 U.S.C. § 1254(1).

STATUTE INVOLVED

The statute involved in this petition is the definition of "security" in the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10), included in the Appendix at A-82. The most pertinent part provides, "When used in this chapter, unless the context otherwise requires – The term "security" means any note . . . ."

STATEMENT OF THE CASE

The financial instruments at issue here are uninsured demand notes that an Arkansas agricultural cooperative ("the Co-Op") sold for many years to thousands of farmers and other members of the public ("the Class").[1] The Co-Op marketed its notes as "safe . . . secure" "investments" and advertised its offerings as the "Coop Investment Program." 635 F. Supp. at 863. When the Co-Op filed for bankruptcy, more than 1600 people held notes which they had purchased for more than $10 million. *Id.* The notes paid a variable rate of interest, which the Co-Op's management adjusted monthly. Both the SEC and the Arkansas Securities Department had, prior to bankruptcy, intermittently asserted jurisdiction over the Co-Op's note program.

The U.S. District Court for the Western District of Arkansas, exercising federal question jurisdiction pursuant to 28 U.S.C. § 1331, determined on the Class' motion for summary judgment that the notes were securities under Arkansas law. 635 F. Supp. at 865-65. In a subsequent unreported opinion, the district court concluded that the demand notes were securities under federal law as well. (The pertinent portion of that opinion is included in the Appendix at A-29.)

After a five-week trial on the merits, the jury concluded that the Co-Op's notes had been sold pursuant to a fraud originated by certain local employees of Arthur Young & Co. ("AY"). The jury found AY liable for violations of federal and state securities laws and awarded the Class approximately $6.1 million in compensatory damages. 856 F.2d at 53.

On appeal, the Eighth Circuit (referring to the so-called *Howey* test)[2] concluded that the Co-Op's notes are not securities

---

[1] Petitioners are Bob Reves, Robert H. Gibbs, and Frances Graham, as representatives of a class of note holders. Respondent is Arthur Young & Co.

[2] *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

under federal law because they were payable on demand and yielded only interest. *Id.* at 54-55. For the same reasons, the panel also held that the notes were not securities under Arkansas law. *Id.* at 55. The Eighth Circuit then reversed the district court and denied the Class any relief from AY. *Id.*

The Class petitioned for rehearing en banc. The SEC and the Arkansas Securities Department filed separate amicus curiae briefs with the Eighth Circuit in support of the Class' rehearing petition. Without issuing an opinion, a majority of the Eighth Circuit denied the Class' petition. However, four circuit judges issued an opinion dissenting from the order. 856 F.2d at 55-56 (Appendix at A-1). The dissent stated in part that "the notes involved in this case meet all the traditional tests of a security. . . . Our panel's conclusion to the contrary appears to commit the Eighth Circuit to a definition of security unique among the federal courts." *Id.* at 56.

REASONS FOR GRANTING THE WRIT

I. Introduction

This Court never has identified the test which should be used to determine when a "note" is a "security" within the scope of the Securities Act of 1933 and the Securities Exchange Act of 1934 ("the Acts"). In fact, just four years ago, the Court expressly reserved decision on this question. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 694 (1985). The courts of appeals have resolved the issue in several different and inconsistent ways. With the Eighth Circuit's decision in this case, there are now four different tests in use.[3] Moreover, the Eighth Circuit created a further conflict among the courts of appeals in holding that demand notes that pay interest can never be "securities."

The Class urges the Court to resolve now these conflicts among the courts of appeals. With all four tests for "notes" in use, the most important factor in determining whether a particular note is a security under federal law will be which court of appeals happens to test the note. The Class suggests that this Court harmonize the law on this point by adopting the "commercial vs. investment" test used by five courts of appeals. Finally, the Class requests the Court to conclude that, under the appropriate test, the uninsured demand notes that the Co-Op offered and sold to thousands of passive investors are "securities."

II. This Court Should Resolve The Conflict Among The Courts of Appeals And Specify The Test Which Should Be Used To Determine Whether A "Note" Is A "Security."

One of the four approaches now in use to determine when a "note" is a "security" is the "commercial vs. investment" test. It has been adopted by the First, Third, Fifth, Seventh, and Tenth Circuits.[4] The test distinguishes between notes executed

---

[3] *See* L. Loss, *Fundamentals of Securities Regulation* 165-69 (1988).

[4] *See, e.g., Futura Dev. Corp. v. Centex Corp.*, 761 F.2d 33, 40-41 (1st Cir.), *cert. denied*, 474 U.S. 850 (1985); *Hunsinger v. Rockford Business Credits,*

(Footnote continued)

as part of a commercial or consumer transaction (such as the making of loans or the purchase of goods) and notes issued in the context of an investment transaction (such as a broad offering to many passive investors). Purchasers of the latter type of notes are dependent on the managerial efforts and financial disclosures of others, and therefore should enjoy the protections of the federal securities laws. *E.g.*, *Futura Dev. Corp.*, 761 F.2d at 40-41.

The *Landreth* Court, in dictum, recognized the importance of context in which a note is sold: " '[N]ote' may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending upon whether issued in a consumer context, as commercial paper, or in some other investment context." 471 U.S. at 694 (citation omitted). While the context of the transaction depends on the circumstances of each case, relevant factors include: (1) the scope and duration of the offering; (2) the number of notes issued, the number of note holders, and the amount involved; (3) how the note is characterized in the offerings, in financial statements, and in the business community; (4) whether the proceeds are to be used for the purchase of particular goods or services (commercial) or for general financing of the enterprise (investment); (5) the extent of reliance on the effort of others; and (6) whether the noteholders are protected by collateral or insurance. *See, e.g.*, *C.N.S. Enterprises v. G & G Enterprises*, 508 F.2d 1354, 1361 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).

A competing approach is the "risk capital" test, used in the Sixth and Ninth Circuits. It turns on whether the holder of the note contributed risk capital to a venture that is subject to the managerial efforts of others.[5] A third test is the Second Circuit's

Inc., 745 F.2d 484, 489 (7th Cir. 1984); *McClure v. First Nat'l Bank*, 497 F.2d 490, 494-95 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Zabriskie v. Lewis*, 507 F.2d 546, 550-51 (10th Cir. 1974); *Lino v. City Investing Co.*, 487 F.2d 689, 693-95 (3d Cir. 1973)

[5] *See Underhill v. Royal*, 769 F.2d 1426, 1431 (9th Cir. 1985); *American Bank & Trust v. Wallace*, 702 F.2d 93, 96 (6th Cir. 1983); *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1257-58 (9th Cir. 1976).

"literal approach," which presumes that notes with maturities in excess of nine months, and which are unrelated to certain commercial and consumer contexts, are "securities."[6]

Finally, in this case, the Eighth Circuit used the *Howey* "investment contract" test to analyze these notes. But, as this Court already has stated, the *Howey* test "was designed to determine whether a particular instrument is an 'investment contract,' not whether it fits within *any* of the examples [such as "notes"] listed in the statutory definition of 'security.' " *Landreth*, 471 U.S. at 691 & n.5 (emphasis in original).[7]

While all four of these tests are in use, the same financial instrument may be considered a "security" in some circuits but not in others. *See, e.g.*, *Futura Dev. Corp.*, 761 F.2d at 41; *McClure*, 497 F.2d at 493-94. For example, in the Eighth Circuit now, a demand note that pays interest, even though it is sold to passive investors in a wide-scale offering, is not a security. However, in the neighboring Seventh Circuit, such a note is a security. *See Hunssinger*, 745 F.2d at 486-93 (callable notes with fixed rates of interest held to be securities). A note holder's entitlement to protection under the federal securities laws simply should not depend on the circuit in which the note holder resides and this Court therefore should announce the proper test to be applied by *all* courts of appeals.

III. The Eighth Circuit Erred When It Decided That The Co-Op's Demand Notes Are Not Securities.

Whatever test this Court adopts, "form should be disregarded for substance and the emphasis should be on economic reality." *See Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). Here, the

[6] *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137-38 (2d Cir. 1976).

[7] "Moreover, applying the *Howey* test to traditional stock and all other types of instruments listed in the statutory definition would make the Act's enumeration of many types of instruments superfluous." *Id.* at 692 (citations omitted). Thus, the *Howey* test is not applicable to notes. *Hunssinger*, 745 F.2d at 491; *Exchange Nat'l Bank*, 544 F.2d at 1136; *Briggs v. Sterner*, 529 F. Supp. 1155, 1167-69 (S.D. Iowa 1981).

plain "economic reality" is that the demand notes at issue were sold as investments by the Co-Op and are securities. As the district court recognized, "[e]ven in the absence of precise rules for distinguishing commercial transactions from investments, common sense tells one that this program is not a commercial loan." 635 F. Supp. at 863.

The Eighth Circuit erroneously ignored or gave little effect to the district court's detailed analysis of the material facts. Instead, the Eighth Circuit decided that the notes are not securities simply because they were payable on demand and yielded only interest. Its decision was wrong. First, except for the Eighth Circuit, no court has held that notes payable on demand (*i.e.*, callable notes) cannot be "securities."[8] Second, the Eighth Circuit reasoned that a note must yield a "profit" to be a security and then concluded that "interest" does not constitute "profit." 856 F.2d at 54-55. This conclusion directly conflicts with the decisions of other courts of appeals that have considered this issue.[9] If allowed to stand, the panel's opinion would — in the Eighth Circuit — read the category "notes" out of the Acts' definitions of "security."

---

[8] *See SEC* v. *World Radio Mission, Inc.*, 544 F.2d 535, 537 (1st Cir. 1976); *Hunssinger*, 745 F.2d at 486-93; *Zeller* v. *Bogue Electric Mfg. Co.*, 476 F.2d 795, 799-800 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Briggs* v. *Sterner*, 529 F. Supp. 1155, 1163, 1169 (S.D. Iowa 1981); *United States* v. *Attaway*, 211 F. Supp. 682, 685 (W.D. La. 1962).

While the Eighth Circuit cites to *Great Western Bank*, 532 F.2d at 1257-58 (9th Cir.) ("A demand or short term note is almost *ipso facto* not a security unless payment depends on a risky enterprise. . . ."), the Co-Op *was* a risky enterprise. Moreover, a subsequent Ninth Circuit case held that certain notes were securities even if they were immediately callable. *Underhill*, 769 F.2d at 1431.

[9] "A fixed rate of interest is simply a characteristic of the general category 'notes.' A note that bears a fixed rate of interest is just as likely to be an investment as it is to be evidence of a commercial loan." *Hunssinger*, 745 F.2d at 489.

The Co-Op paid variable, higher-than-market-rate interest on the notes it sold. Notes with similar interest structures have been held to be securities.

(Footnote continued)

The Eighth Circuit simply ignores the enormous scale and duration of the Co-Op's "Investment Program,"[10] as well as the fact that the Class was not protected by any regulatory scheme other than the securities laws.[11] The judgment of the Eighth Circuit is legally and factually indefensible, and this Court's application of the appropriate test should require the reversal of the judgment below.

See Gary Plastic Packaging Corp. v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 235, 240-42 (2d Cir. 1985) (defendants controlled interest rates on money market funds, held to be securities). Also held to be securities are notes whose rates varied with the prime rate, *Hunssinger*, 745 F.2d at 488-91, and notes with a fixed rate of interest. *World Radio Mission*, 544 F.2d at 537; *Briggs*, 529 F. Supp. at 1168; *SEC* v. *Thunderbird Valley, Inc.*, 356 F. Supp. 184, 188 & n.3 (D.S.D. 1973); *People* v. *Walberg*, 69 Cal. Rptr. 457, 461 (Dist. Ct. App. 1968) (state act).

[10] Federal courts often have relied on the broad scale of an offering in holding that the instruments offered for sale were securities. *E.g.*, *Underhill*, 769 F.2d at 1429–31; *Hunssinger*, 745 F.2d at 492; *Sanders* v. *John Nuveen & Co.*, 463 F.2d 1075, 1079-81 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

[11] Thus, the reasoning of *Marine Bank* v. *Weaver*, 455 U.S. 551, 556-59 (1982) (FDIC-insured certificates of deposit not securities), is not applicable here.

CONCLUSION

For the reasons stated above, this petition for a writ of certiorari should be granted.

Respectfully submitted,

GARY M. ELDEN
(Counsel of Record)
JOHN R. MCCAMBRIDGE
JAY R. HOFFMAN

Attorneys for Petitioners

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

Arthur Young & Co.,

Appellant,

vs.

Bob Reves, et al,

Appellees.

Thomas E. Robertson, Jr., etc., et al,

Appellants/Cross-Appellees,

vs.

Arthur Young & Co.,

Appellee/Cross-Appellant.

Robert R. Cloar, etc.,

Appellant,

vs.

Bob Reves,

Appellee.

Appeals from the United States
District Court for the
Western District of Arkansas
H. Franklin Waters, Chief Judge
Nos. 87-1726-WA, 87-1727WA, 87-1803WA,
87-2533WA, 88-1014WA

OPINION OF DENIAL OF REHEARING AND REHEARING EN BANC
DECEMBER 2, 1988

Petition for rehearing en banc of appellees/cross-appellees, Robertson & Reves, et al, has been considered by the Court and is denied.

Petition for rehearing by the panel is also denied.

[Reported at 856 F.2d 55]

ARNOLD, Circuit Judge, with whom LAY, Chief Judge, HEANEY and JOHN R. GIBSON, Circuit Judges, join dissenting.

I vote to grant the petition for rehearing en banc.

It seems to me that the notes involved in this case meet all the traditional tests of a security. The statute, of course, expressly includes "notes" in its definition, so one begins at least with a presumption that notes are covered. It remains true that some notes are not "notes" as the statute uses the

term -- for example, a note I sign to evidence a loan from a friend or a bank. But the notes at issue here are poles apart from such a case of personal or commercial credit. They were sold to large numbers of relatively unsophisticated investors; their purpose is to raise capital which will be put at risk in the insurer's business; and those who buy them expect to reap a benefit in the form of interest payments. So even if these notes have to meet the traditional test for "investment contracts," they clearly qualify. Our panel's conclusion to the contrary appears to commit the Eighth Circuit to a definition of security unique among the federal courts.

The panel's almost casual rejection of the District Court's view of Arkansas law also disturbs me. We normally defer to district judges' interpretations of the law of their own states. My own attitude when

hearing appeals on such questions is roughly akin to the posture of appellate judges when reviewing questions of fact. That is, I am inclined to reverse on state-law questions only when the decision below is clearly erroneous. Such a use of question-of-fact standard is not so strange as it may at first appear. Questions of foreign law are traditionally treated as questions of fact. And, while the law of a state is obviously not "foreign" to us in the same way as, say, the law of Afghanistan, a judge of a federal appellate court whose legal upbringing was in Arkansas cannot be expected to have the same instinctive feel for the law of North Dakota as a judge of that State. One can look at all the law books in print and still not have the same degree of reliable judgment on legal questions as a lawyer who has lived and practiced for years in the

jurisdiction. There is such a thing as what Dean Pound called "law in action," as opposed to "law in the books." Each State has its own distinct legal ethos which informs and qualifies how lawyers and judges understand what is written in the law books. So when we defer to the opinions of district courts on the law of their own states, we are not shirking our responsibilities. We are simply using common sense.

Here, the District Court's opinion on the meaning of the Arkansas securities statute seems to me more carefully analyzed than the opinion of our panel. But even if it did not, I would still be inclined to affirm. There is no reported Arkansas state-court opinion that contradicts the District Court's view, nor is there anything logically deficient about its analysis. The regulatory attitude of the

Arkansas Securities Department, and the history of the Arkansas General Assembly's treatment of the exemption for notes issued by agricultural cooperatives point strongly in the same direction. See Robertson v. White, 635 F. Supp. 851, 856-58 (W.D. Ark. 1986) (the opinion of Chief Judge Waters in this case).

One other observation about the panel's holding on Arkansas law: it binds no one except the parties to this case (by res judicata) and the federal courts in this Circuit (by stare decisis). It does not bind the Arkansas state courts or the Arkansas Securities Department. Our decisions on state law can be accepted by the state courts if they find them persuasive, but they need not be. Stare decisis, as a doctrine of binding precedent, applies only to courts at the same or a lower level in a single

hierarchical system. We have no supervisory or appellate jurisdiction over the state courts. So when this question comes before the Arkansas state courts (if it does), they are free to differ from our panel's conclusion. I hope that they will differ. And if the Arkansas Supreme Court decides the question differently from our panel, this Court will thereafter be bound by that decision. The Supreme Court of Arkansas has the last word on the law of Arkansas.

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

ARTHUR YOUNG & CO.,

Appellant,

v.

BOB REVES; ROBERT H. GIBBS; & FRANCES GRAHAM,

Appellees.

THOMAS E. ROBERTSON, JR., as trustee of the Farmer's Co-Op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, who are similarly situated to him; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds,

Appellants,

v.

ARTHUR YOUNG & CO.,

Appellee.

THOMAS E. ROBERTSON, JR., as trustee of the Farmer's Co-Op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, who are similarly situated to him,

Appellees,

v.

ARTHUR YOUNG & CO.,

Appellant.

THOMAS E. ROBERTSON, JR., etc., et al. vs. JACK WHITE, et al.

THOMAS E. ROBERTSON, JR., as trustee of the Farmer's Co-Op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, who are similarly situated to him; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds,

Appellees,

v.

ARTHUR YOUNG & CO.,

Appellant.

THOMAS E. ROBERTSON, JR., etc.
et al. vs. Jack White, et al.

ROBERT R. CLOAR, Class Counsel,

Appellant,

v.

BOB REVES,

Appellee.

Appeals from the United States
District Court for the
Western District of Arkansas
H. Franklin Waters, Chief Judge
Nos. 87-1726, 87-1727, 87-1803
87-2533, 88-1014

MEMORANDUM OPINION
SUBMITTED MAY 9, 1988
FILED SEPTEMBER 2, 1988

[Reported at 856 F.2d 52]

Before FAGG and MAGILL, Circuit Judges, and SNEED,* Senior Circuit Judge.

MAGILL, Circuit Judge.

*THE HONORABLE JOSEPH T. SNEED, Senior United States Circuit Judge for the Ninth Circuit, sitting by designation.

This case arose out of the bankruptcy of the Farmer's Cooperative of Arkansas and Oklahoma, Inc. (Co-Op). A class comprised of the holders of demand notes (Class) issued by the Co-op obtained a $6.1 million judgment against the Co-op's independent auditors, Arthur Young & Co. (Arthur Young).[1] The judgment followed a jury verdict that Arthur Young violated section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b) (Federal Act) and section 67-1256 of the Arkansas Securities Act, Ark. Stat. Ann. § 67-1256 (Arkansas Act) (recodified at Ark. Code Ann. § 23-42-106 (1987)), in connection with the sale of demand notes by

[1]Although at one point this action involved more than a dozen claims by the bankruptcy trustee (Trustee) and the Class against approximately forty defendants, this appeal involves only the claims against Arthur Young.

the Co-Op.

Arthur Young appeals the district court's (1) denial of its motion for a new trial or judgment n.o.v.; (2) award of costs to the Trustee and the Class; (3) aware of attorney's fees to Class counsel; (4) calculation of pre- and post-judgment interest; and (5) denial of its petition for costs against the Trustee and the Class.

The Class cross-appeals, claiming that the district court erred in crediting settlement proceeds against the jury verdict against Arthur Young, and in granting summary judgment in favor of Arthur Young on the Class' claim under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-1968.

The Trustee cross-appeals the dismissal of his breach of contract claim.

Because we believe that the demand notes at issue are not "securities" for purposes of either federal or Arkansas security acts, we reverse the denial of Arthur Young's motion for j.n.o.v. Furthermore, we deny the Class' and Trustee's cross-appeals.

I. BACKGROUND

In light of our disposition, only a brief recitation of the facts is necessary. Prior to retaining the services of Arthur Young in 1981, the Co-Op had, for the most part, operated a traditional farmer's cooperative in northwest Arkansas and northeast Oklahoma. One of its financing methods, however, was not traditional, and it provides the focus for this lawsuit.

The Co-op was a membership organization for the farmers it served; it charged only a nominal membership fee. The

Co-op obtained some of its operating funds not from traditional borrowing sources such as banks, but rather from the sale of promissory notes (demand notes) to its members. The practice involved the payment of money to the Co-op by a member in exchange for a promissory note payable on demand, at a rate of interest higher than could be obtained from area banks or savings and loans. The rate of interest changed periodically, based on market conditions, and those changes were announced in the Co-op's newsletter. The sale of the demand notes was an ongoing activity, and no financial information regarding the Co-op was disclosed to the members at the time of sale except for a statement of the Co-op's total assets, which was released by the Co-op periodically. All members of the Class held demand notes.

Arthur Young was engaged by the Co-op to audit and report on its 1981 and 1982 financial statements. Neither the Co-op's management nor its board of directors disseminated the audited financial statements to either the Co-op's members or its demand noteholders. The only dissemination of financial information by the Co-op occurred at its annual meetings. Its management created condensed financial statements, and these were distributed to the approximately 350 members, a small fraction of the total Co-op membership, who attended the meetings.

At both the 1982 and 1983 meetings, Arthur Young representatives spoke briefly. They informed the members that the full audited financial statements, together with Arthur Young's report on them, were available at the Co-op's office. They also made a presentation of approximately ten

minutes describing the general financial status of the Co-op.

The Class argued that Arthur Young deliberately failed to follow generally accepted accounting principles and, specifically, intentionally failed to follow Accounting Principles Board Opinion 16 with respect to its valuation of one of the Co-op's major assets, a gasohol plant. The Class maintained that had Arthur Young properly treated the gasohol plant, the Co-op's insolvency would have been readily apparent. The Class contended that Arthur Young avoided the correct accounting treatment and lied about its reasons for so doing, in order to inflate the assets and net worth of the Co-op. The Class asserted that Arthur Young "originated" fraudulent statements and omissions, and that the demand notes were purchased in reliance upon these statements and omissions.

Prior to trial, the district court granted summary judgment to Arthur Young on the Class' RICO claim and dismissed the Trustee's breach of contract claim. The jury found in favor of Arthur Young on the Trustee's fraud and negligence claims and in favor of the Class on the securities claims. This appeal and cross-appeal followed.

II. DISCUSSION

A. Arthur Young's Appeal

The first issue is whether the demand notes are securities within the meaning of the Federal Act. While the Federal Act defines a security as "any note," 15 U.S.C. § 78c(a)(10), it is nevertheless well settled that these definitional sections are not to be read literally because "Congress intended the application of [the federal securities acts] to turn on the economic realities

underlying a transaction and not on the name appended thereto," United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849, 95 S. Ct. 2051, 2059, 44 L.Ed.2d 621 (1975), and an instrument which seems to fall within the broad sweep of the federal acts is not to be considered a security "if the context otherwise requires." Marine Bank v. Weaver, 455 U.S. 551, 556, 102 S. Ct. 1220, 1223, 71 L.Ed.2d 409 (1982); see Smith International, Inc. v. Texas Commerce Bank, 844 F.2d 1193, 1199 n.4 (5th Cir. 1988); cf., Landreth Timber Co. v. Landreth, 471 U.S. 681, 105 S. Ct. 2297,

85 L.Ed.2d 692 (1985).[2] Thus, "the wide-ranging definition of a security found in the [Federal] Act is limited by congressional intent not to provide a broad federal remedy for all fraud and by the Supreme Court's practical approach to interpreting the federal securities laws." Union National Bank of Little Rock v. Farmers Bank, 786 F.2d 881, 884 (8th Cir. 1986) (footnote omitted).

For the demand notes at issue to be considered securities under the Federal

---

[2]The Supreme Court has held that when an instrument bears both the name and all usual characteristics of "stock," it is not necessary to determine whether application of the federal securities acts is mandated by the economic substance of the transaction. Landreth, 471 U.S. at 693-94, 105 S. Ct. at 2305-06.

The Court has specifically declined to determine whether the same is true of "'notes' or 'bonds' or some other category of instrument listed in the [Federal Act's definition of security]." Id. at 694, 105 S. Ct. at 2306.

Act, they must satisfy the elements of the test developed in SEC v. W.J. Howey Co., 328 U.S. 293, 66 S. Ct. 1100, 90 L.Ed. 1244 (1946); see Farmers Bank, 786 F.2d at 884; Kansas State Bank v. Citizens Bank, 737 F.2d 1490, 1494-95 (8th Cir. 1984). Even if the Supreme Court should determine it inappropriate to apply the Howey test to an instrument which bears both the name "note" and the usual characteristics of a security, see supra n.2, it is no bar in this case because the instrument at issue, while possessing the name, lacks the characteristics.

The demand nature of the notes is very uncharacteristic of a security. "A demand or short-term note is almost ipso facto not a security unless payment is dependent upon the success of a risky enterprise or the parties contemplate indefinite extension of the note or perhaps

conversion to stock." Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1257-58 (9th Cir. 1976); see Kansas State Bank, 737 F.2d at 1494. Neither of the conditions is present here. Because the demand notes are uncharacteristic of a security, we look to the economic reality of the transaction to determine their status. See Howey, 328 U.S. 293, 66 S. Ct. 1100, 90 L.Ed. 1244 (1946).

The Howey test defines a security as (1) an investment; (2) in a common enterprise; (3) with a reasonable expectation of profits; (4) to be derived from the entrepreneurial or managerial efforts of others. Id. at 301, 66 S. Ct. at 1104.

Applying this standard, we conclude that the demand notes are not securities under federal law. First, these notes were short-term loans with fixed interest rates

which were used for operating funds. See Farmers Bank, 786 F.2d at 884-85. The Co-op initiated this program because it could obtain funds at rates lower than those offered by banks; the members "deposited" their money with the Co-op in order to earn a higher return than could be obtained from a bank. Thus, under the first element of the Howey test, this transaction was much more akin to a commercial lending arrangement than an investment transaction. See Farmers Bank, 786 F.2d at 884-85. Moreover, the third element of the Howey test, i.e., a reasonable expectation of profit, is lacking in this case.

> Profit, however, does not mean any return beyond principal. Rather, it is profit of the type typically associated with an investment. This includes 'capital appreciation resulting from the development of the initial investment * * * or a participation in earnings resulting from the use of investors' funds * * *.

Kansas State Bank, 737 F.2d at 1495,

quoting Forman, 421 U.S. at 852, 95 S. Ct. at 2060. Here, the interest rate was fixed by an established market rate. The demand noteholders did not participate in the Co-op's earnings by virtue of their ownership of the demand notes, nor was there any prospect of capital appreciation. Therefore, the demand noteholders did not expect a "profit" as that term is defined in Howey.

Because these demand notes were uncharacteristic of securities, and also failed the Howey test, we conclude that they were not securities within the meaning of the Federal Act. The Class has thus failed to state a claim under section 10(b) of the Federal Act, 15 U.S.C. § 78j(b).

The second issue is whether the demand notes are securities within the meaning of the Arkansas Act. In Smith v. State, 266 Ark. 861, 587 S.W.2d 50, 52

(App. 1979), cert. denied, 445 U.S. 905, 100 S. Ct. 1082, 63 L.Ed.2d 321 (1980), the Arkansas Court of Appeals identified five significant common characteristics of a security: (1) the investment of money or money's worth; (2) investment in a venture; (3) the expectation of some benefit to the investor as a result of the investment; (4) contribution towards risk capital of the venture; and (5) the absence of direct control over the investment or policy decisions concerning the venture. Judge Harris, a senior district judge for the Western District of Arkansas, recently held that "[t]he Arkansas definition of a security is essentially identical to the definition under the federal securities laws and the criteria followed [in Smith and Howey] in making a determination on whether an instrument is a security is also the same." First Financial Federal Savings

& Loan Assn. v. E.F. Hutton Mortgage Corp., 652 F. Supp. 471, 475 (W.D. Ark.), aff'd, 834 F.2d 685 (8th Cir. 1987).[3] See Farmers Bank, 786 F.2d at 885. It follows, therefore, that the Class is not entitled to relief under the Arkansas Act. Accordingly, the district court's denial of Arthur Young's motion for j.n.o.v. is reversed.

This disposition requires us to vacate the district court's award of fees and costs in favor of the Class and Trustee and against Arthur Young. Moreover, the case is remanded, and the district court is directed to award reasonable costs to

---

[3]While this court affirmed the district court in First Financial, it found it unnecessary to resolve the question whether the Howey and Smith tests are substantially the same. First Financial, 834 F.2d at 688. We now decide, agreeing with Judge Harris, that the tests are essentially the same.

Arthur Young and against the Class and the Trustee. See Fed. R. Civ. P. 54(d).

B. **The Class' Cross-Appeal**

In view of our decision with respect to the securities claims, it is unnecessary to discuss the Class' contentions regarding the district court's order requiring the crediting of settlement proceeds.

The Class next challenges the district court's entry of summary judgment in favor of Arthur Young on the Class' RICO claim. It is not necessary to review the district court's decision on this issue because our disposition of the securities claims means that no predicate acts exist which could form the basis for RICO liability. See 18 U.S.C. § 1961(5); Sedima, S.P.R.L. v. Imrex Company, Inc., 473 U.S. 479, 485, 105 S. Ct. 3275, 3279, 87 L.Ed.2d 346 (1985). This is true

despite the fact that the complaint in this case also alleged mail and wire violations, because the Class did not pursue these claims below or on this appeal.

C. **The Trustee's Cross-Appeal**

The Trustee contends that the district court erred in dismissing his breach of contract claim against Arthur Young. Finding no error of fact or law, we affirm this portion of the district court's decision.

III. CONCLUSION

The judgment of the district court denying Arthur Young's motion for j.n.o.v. on the securities claims is reversed. The award of costs and fees to the Class and the Trustee is vacated, and the case is remanded for a determination as to the appropriate amount of costs to be awarded to Arthur Young.

As to the cross-appeals, we affirm

the denial of the RICO claim, based on the absence of the required predicate acts, and we affirm the dismissal of the Trustee's contract claim.

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as Trustee of the Farmer's Co-Op of Arkansas & Oklahoma, Inc.; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds,

Plaintiffs,

v.

JACK E. WHITE, et al.,

Defendants.

Consolidated Cases No. 85-2044,
85-2096, 85-2155, 85-2259
H. Franklin Waters, Chief Judge

MEMORANDUM OPINION
FILED OCTOBER 15, 1986

I. INTRODUCTION

[Text omitted].

II. COUNT I: RETURN OF FEES PAID BY THE CO-OP

[Text omitted].

III. COUNT II: FRAUD, NEGLIGENCE, AND CONSPIRACY IN TRANSFER OF GASOHOL PLANT

[Text omitted].

IV. COUNT III: SECURITIES FRAUD IN TRANSFERRING WHITE FLAME STOCK TO THE CO-OP

[Text omitted].

V. COUNT IV: NEGLIGENCE AND FRAUD IN ALLOWING THE CO-OP TO CONTINUE IN OPERATION AFTER INSOLVENCY

[Text omitted].

VI. COUNT VI: ACTIONS UNDER STATE AND FEDERAL SECURITIES LAWS CLAIMS

[Text omitted].

A. NON-REGISTRATION CLAIMS:

The court has previously held the Co-op demand notes to be "securities" for purposes of the Arkansas securities laws requiring registration or exemption. Robertson v. White, 635 F. Supp. 853 (W.D. Ark. 1986). We did not then decide whether the notes were "securities" for purposes of the federal laws, but we now so hold.

[Remainder of section omitted].

B. FRAUDULENT SALES OF DEMAND NOTE SECURITIES UNDER RULE 10b-5 AND THE ARKANSAS BLUE SKY LAW

[Text omitted].

VII. COUNT XII: RICO ACTIONS AGAINST THE LAWYERS AND ACCOUNTANTS

[Text omitted].

VIII. CONCLUDING MATTERS

[Text omitted].

An order will be issued contemporaneously herewith embodying these conclusions.

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as Trustee of the Farmer's Co-Op of Arkansas & Oklahoma, Inc.; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds; and Bob Reves; Frances Graham; and Robert H. Gibbs as Class and Subclass Representatives,

Plaintiffs,

v.

JACK E. WHITE, et al.,

Defendants.

Consolidated Cases No. 85-2044,
85-2096, 85-2155, 85-2259
H. Franklin Waters, Chief Judge

MEMORANDUM OPINION
FILED JUNE 10, 1986

[Reported at 635 F. Supp. 851]

The plaintiff class, holders of demand notes issued by the Farmers Co-op of

Arkansas and Oklahoma, Inc., has moved for summary judgment on its state securities law claims against certain Co-op directors and employees. The class alleges that the Co-op demand note program constituted a sale of "securities" as that term is defined in the Arkansas Securities Act. Ark. Stat. Ann. §§ 67-1235 et seq. (1980 Repl.). The class maintains that inasmuch as these demand notes were neither registered during the period April 8, 1980, to October 28, 1983, nor validly exempt from registration, the sales were unlawful. They filed this motion to rescind the purchases of unregistered demand notes, and to recover the consideration paid plus six percent (6%) interest as provided by law. Ark. Stat. Ann. § 67-1256(a)(2) (1980 Repl.).

The district court referred this question to the magistrate pursuant to a

pre-trial referral order previously entered in June, 1985. On March-27, 1986, the magistrate issued his proposed findings and recommendations. He found that the demand notes were securities under the Arkansas Securities Law, and that Jack White, the Co-op's general manager during part of the period, performed the functions of a corporate president, and was therefore liable under Ark. Stat. Ann. § 67-1256(b). The magistrate believed that Kirit Goradia, the Co-op office manager, raised a material issue of fact as to whether he performed the duties of a corporate officer, or "materially aided" the sale of the notes. He therefore denied summary judgment against Goradia.

With respect to the Co-op's directors, the magistrate found that they were persons explicitly made liable under the statute, without regard to whether they

aided a sale or performed executive duties. Ark. Stat. Ann. § 67-1256(b). He found, however, that the directors' affidavits made out a submissable case that they did not know, and in the existance of facts by virtue of which the liability is said to exist.

All parties filed timely objections to the magistrate's proposed findings and recommendations. In addition, the court has reviewed an amicus filing from Arthur Young & Co., which wished to advise the court of its position that the Co-op demand notes are not "securities." Arthur Young believes that a ruling unfavorable to the defendants may foreclose argument on a cognate issue under the federal acts. The court does not believe that its resolution of state law questions necessarily settles the federal securities issue. The court has devoted considerable attention to the

legislative history of the Arkansas Securities Act of 1959. This history, in several particulars, is distinct from that of the Securities Act of 1933, and of the Securities Exchange Act of 1934. Whether those differences are so critical as to mandate a different result, the court reserves for further argument on another day, although federal precedents will necessarily be discussed in this opinion.

A. Are Demand Notes "Securities" Under Arkansas Law

The parties have closely argued the question whether the Co-op's demand notes are "securities" subject to regulation by the Arkansas Securities Act. Ark. Stats. Ann. §§ 67-1235 et seq. The Act provides:

> 67-1247. Definitions of Terms Used. When in this act, unless the context otherwise requires: ...
>
> (1) "Security" means any note; stock; treasury stock; bond; debenture; evidence of indebtedness; ... or in general any interest or

> instrument commonly known as a "security" .... (emphasis added).

The magistrate found that the instruments issued by the Co-op were "notes" or "evidence of indebtedness" included within the definition of "security" set forth in the statute. The Eighth Circuit, however, has held that not every note is a security for purposes of either the Arkansas or the federal securities acts. See Union National Bank v. Farmers Bank, 786 F.2d 881 (8th Cir. 1986).

The United States Supreme Court, in dicta, has also questioned whether all notes should be treated as securities under federal law. Landreth Timber Co. v. Landreth, [471 U.S. 681], 105 S. Ct. 2297, 2306, 85 L.Ed.2d 692 (1985). While we are only concerned with the Arkansas Securities Act, we must acknowledge that Arkansas's

definition of "security" is borrowed from that of the Securities Act of 1933, 15 U.S.C. § 77(b). Distinctive features of the Arkansas Act impel us to the conclusion that demand notes issued by a farmers' cooperative are securities, and that these particular features, combined with state and federal court interpretations of relevant sections of the Act, allow our conclusion to stand alone.

Nevertheless, Kansas State Bank v. Citizens Bank, 737 F.2d 1490, 1495-96 (8th Cir. 1984), urges that even in state Blue Sky Law cases, some attention be paid to federal precedents, and we shall do so. We believe, however, that our analysis of the Arkansas act permits us to conclude, as a matter of summary judgment, that the demand notes are securities. We hope that our opinion offers "a carefully reasoned ruling on a question of state law" sufficient to

satisfy the Kansas State Bank court's concern on this point. Id. at 1496.

Our opinion will therefore proceed to analyze the question on the basis of the Arkansas Securities Act, its history, development, and interpretation in both the state and federal courts. Secondary sources will include not only a learned commentary on the state court's interpretations of the securities laws, but also an article specifically cited by the state court as an authoritative guide for the resolution of this question.

Federal precedents, too, will be examined to determine whether these notes are disqualified from being treated as securities under the federal statutes. Federal courts have found certain kinds of notes to be securities, and contrarily. We believe that salient features of the notes offered by the Farmer's Co-op of Arkansas

and Oklahoma, Inc., direct a conclusion that a broad scale offering of unsecured debt instruments to a passive public constitutes an investment transaction, rather than a commercial loan.

Turning now to our analysis of the state law, we believe that the Arkansas General Assembly intended note programs such as the Co-op's to be subject to review by the securities commission. The first word of the definition of security is "note." Presumptively, notes issued by a corporation to generate capital are securities. Granted, under the plain language of the statute, an isolated personal loan of $100.00, evidenced by an I.O.U., can be deemed a security. Such a transaction would qualify for an exemption, Ark. Stat. Ann. § 67-1248(b)(9); that, however, does not answer the point. Such a borrower would have to qualify it through

the securities commission, and would incur administrative expenses far in excess of the "proceeds" of the "issue."

On the other hand, it is equally absurd to suppose that a "note" or "evidence of indebtedness" can never be a security subject to state regulation. Such an interpretation would require the court to hold that the words are inappropriately included in the statute. Defendants, in fact, urge this court to hold that no instrument can ever be deemed a security unless it possesses "all of the characteristics typically associated with a security," Gould v. Ruefenacht, [471 U.S. 701], 105 S. Ct. 2308, 2311, 85 L.Ed.2d 78 (1985), including, presumably, equity in the enterprise. Such a view encourages

Ponzi schemes.[1] One can easily imagine how promoters of scantily capitalized corporations might secure investment by promising high rates of interest, exceeding those available under long-term CDs, but unencumbered by substantial penalties for early withdrawal. Initial investors could be paid from funds of subsequent depositors. Their "success" would encourage still more gullible souls to invest their savings in the enterprise. Unfettered by regulation of any kind, the promoters could trumpet that such notes are "just like a bank account," instantly liquid, but far more profitable, paying

---

[1]Charles Ponzi was a Boston "financier" who dazzled sophisticated East Coast investors. His concern, ironically named the Securities Exchange Co., promised 50% interest on 45-day notes. When he was thrown into bankruptcy in August, 1920, six Boston banks closed. "Ponzi schemes" often feature notes whose repayment is "guaranteed." They are pyramid schemes.

interest thrice the passbook rate. Unsophisticated investors could be conned away from the regulated and insured world of banking by dark remarks hinting that the banks cheat their depositors. After all, "everyone knows" that capital appreciates at an annual rate of 20 per cent or so, and that "eastern bankers" grow rich by paying only 5 or 6 per cent to the plain people of Arkansas.

Scams such as these have invariably collapsed under their own weight. State law security regulation predates federal enactments, and are familiarly known as Blue Sky Laws. They are designed to combat airy investment schemes, and to protect a gullible public. The vehicle by which this is done is the imposition of personal liability on every person who controls a seller, every partner, officer, director, or person occupying a similar status, and

every employee who materially aids the sale of a security. Ark. Stat. Ann. § 67-1256(b).

The penalties for sale of securities without registration or exemption are slight. They allow the purchaser to rescind the transaction and collect a minimal 6 per cent interest. Ark. Stat. Ann. § 67-1256(e). The statute is remedial, not punitive, and is to be liberally construed in favor of investors. Those persons made liable under the statute are those who stand to profit from the solicitations, or those who enable the project to succeed. It requires such persons to report accurately the financial status of their company, to submit to oversight, and to inform the public of the risks of the enterprise. (In the case of actual fraud, more onerous damages may be recovered, but this is no more than is

allowed at common law.)

The extent of the liability for trespassing the law is peculiarly within the defendants' power to limit. All men are charged with knowledge of the law. That a given offering involves a securities question is more or less apparent, perhaps less so in the case of a note than in the case of sales of stock. But in the twilight of the twentieth century it should hardly come as a surprise that government pervasively regulates the broad-scale solicitation of capital for investment. In this case over $10,000,000 was raised from more than 1600 persons. No one supposes that such a level of financing could ever be obtained from a bank or from an individual without the most thorough screening and the soundest collateral. To suppose that a state would trouble itself to define a security as a "note" and then

permit broad-scale solicitation of its citizens, inviting them to loan vast amounts of money without security, is essentially to suggest that no note can ever be a security no matter what the statute says.

We are, in fact, absolutely convinced otherwise. The legislative history, sources, and subsequent interpretation of the Arkansas Securities Law fully convince us that the Co-op's program is a classic securities transaction, which requires registration or exemption.

In 1959, the Arkansas General Assembly enacted its variant of the Uniform Securities Act. The Hon. Charles Stewart, attorney and legislator, reported on this development in Note, Arkansas Securities Act of 1959, 13 Ark. L. Rev. 323, 324 (1960), saying:

> By 1958, the Uniform Securities Act had been adopted in something like complete form by Hawaii, Kansas and Virginia. The Virginia statute was modeled on an earlier draft of the Act. Arkansas Act 254 of 1959 was introduced into the Senate incorporating verbatim the entire Uniform Securities Act as approved by conference in 1956. Before final passage by the legislature, a considerable number of amendments had been attached to the Senate Bill, making in most cases minor changes with regard to the Uniform Act; however, because of its differences, the title of the act was changed to the Arkansas Securities Act.

In the Uniform Securities Act, § 402(a)(12), the commissioners advised state legislators to "insert any desired exemption from co-operatives." The commissioners explained their hesitance to prescribe a specific formula for regulating, or exempting securities issued by cooperatives as follows:

> At least eighteen states (Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Massachusetts, Minnesota, Missouri, Montana, North Dakota, Ohio, Oregon, South Dakota, Texas, Vermont, Virginia and Wisconsin) contain exemptions for securities issued by

co-operatives, but their provisions vary so sharply that no common pattern can be found. This presumably reflects varying attitudes towards cooperatives quite apart from the blue sky laws. For these reasons it was not practicable to draft a specific exemption for co-operatives. If one is desired, it should be inserted here."

The Arkansas Securities Act of 1959 contained no exemption for cooperatives. In 1975, the General Assembly by Act 894, § 8, offered an exemption to agricultural cooperatives by amending the original to read:

> Section 8. Subsection (a) of Section 14 of Act 254 of 1959, as amended, ... is hereby amended to add subsection (12) to read as follows:
>
> (a) * * * *
>
> (12) any security, other than preferred stock sold or offered for sale to non-members, issued by any agricultural cooperative associations organized other than under the laws of this state.

This cooperative exemption was amended by Act 493 of 1977 in the next legislative session to read:

> Section 7. Paragraph 12 of subsection (a) of Section 14 of Act 254 of 1959, as amended, ... is hereby amended to read as follows:
>
> (12) Only equal voting common stock or equal voting membership securities issued solely to members by a cooperative association organized and operated as a non-profit corporation under Act 116 of 1921.... No commissions or other remuneration may be paid in connection with the offer or sale of such securities.

In the next legislative session, by Act 759 of 1979, the present law was enacted, which has escaped revision. This statute exempts securities issued by farm cooperatives as follows:

> (12) The following shall apply to farm cooperatives organized and operated in this State ... and to any nonprofit farm cooperative which is qualified to do business in this State:

> (1) Any common stock, preferred stock, promissory note or debenture may be issued to any cooperative member after compliance with subsection (c).... (emphasis added).

This exemption is not absolute, but qualified, and only given after the cooperative has applied for and proven its qualifications for the exemption. Such a procedure is also required for so-called "non-public offerings." See Ark. Stat. Ann. § 67-1248(b)(9).

The legislative history demonstrates that the General Assembly gave a great deal of attention to the special problems of securities issued by cooperative associations, and farm cooperatives specifically. The state securities department was certainly aware of the means by which farmers' co-ops obtained their financing, and of demand note programs like the one involved in this

litigation. Defendants' affidavits reflect that the securities department began investigating the Co-op's program in 1975 or 1976 (i.e., Brewer's affidavit, p. 3), and that the department informed the Co-op of the 1977 amendment. Id. The 1979 amendment specified that co-op promissory notes could be exempted securities, provided that the issuer file for an exemption. Without exemption, the securities had to be registered. The 1979 amendment identified the very instrument before us -- a promissory note issued by a farmers' cooperative -- and designated it as a "security" subject to exemption or registration. Amicus counsel for Arthur Young suggests that the demand nature of the Co-op's notes is not characteristic of a security. It is, however, a feature of a promissory note that the law implies that payment is due on demand if time is not

otherwise specified in the instrument. Huyck v. Meador, 24 Ark. 191 (1866). Cf. U.C.C. § 3-104(c). That the legislature specifically recognized cooperative-issued promissory notes as securities eligible for exemption is convincing evidence, we believe, that such instruments were meant to be regulated.

Furthermore, the Arkansas Securities Act of 1959 replaced the Securities law of 1947. The 1947 Securities Act exempted all "unsecured commercial paper." Act 1947, No. 397 § 5(c). This exemption was not carried forward into the 1959 Act except for so-called "prime" commercial paper. Ark. Stat. Ann. § 67-1248(a)(9). This convinces us that the legislature, far from narrowing the definition of "security" to exclude most notes, has broadened the definition so as presumptively to include most debt

instruments as securities, save in those contexts where it would be inappropriate.

While the Arkansas Supreme Court has not addressed the specific question raised in this case, its decisions in other cases provide sure and steady guides. In Note, A Definition of "Investment Contracts" and Equitable Defenses to Suit for Rescission for Nonregistration Under the Arkansas Securities Act, 1 U.A.L.R. L.J. 366 (1978), the writer suggests that Arkansas's concept of what constitutes a security is flexible, following the approach first suggested by the Minnesota Supreme Court in State v. Gopher Tire & Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920). The Arkansas Supreme Court chose this approach so that the statute might "encompass the endless succession of new and innovative or old and tired promotional schemes, where the promoters, by design

seek to risk the money or property of others in their venture." Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 552 S.W.2d 4, 8 (1977).

A flexible approach is less desirable in the context of a criminal prosecution than in a civil case. Accordingly, the court next held in Smith v. State, 266 Ark. 861, 587 S.W.2d 50 (1979), that five elements determine whether a given transaction involves the sale of a "security." The elements are: (a) the investment of money or money's worth; (b) in a venture; (c) the expectation of some benefit to the investor as a result of the investment; (d) the contribution towards the risk capital of the venture; and (e) the absence of direct control over the investment or policy. This test was devised by a scholar, who published it in a law review article cited

by the court as the source for its holding: Long, An Attempt to Return Investment Contracts to the Mainstream of Regulation, 24 Okla. L. Rev. 135 (1971).

Under the Smith test, these demand notes are securities. Obviously, money was invested in the Co-op with the expectation that the investor would receive a benefit from his entrustment. This is not seriously disputed by the defendants. In fact, it is not disputed at all. Defendants maintain that a stated rate of interest cannot be a "profit," and borrow dicta from federal cases to substantiate their point. But surely the state intends to protect its citizens from schemes whereby institutions promise extravagant interest on savings-like accounts whose instant liquidity attracts the savings of its workers. As the law review article credited to be the source of the Smith test

explained:

> The third significant common characteristic of traditional securities is the expectation of some kind of benefit from the investment. In this case of bonds, notes, or debentures, it is the interest paid."

24 Okla. L. Rev., at 144.

Again, if "interest" is not a "profit" within the meaning of securities, then no note, bond, or debenture can ever by regulated by such statutes. This would mean that the greater part of all investment capital would be exempt from any kind of regulation because promoters would label the benefits from their activities as "interest." It would be odd indeed that a promoter would be liable for making "double your money" pie-in-the-sky promises of "profits" and "dividends," but could entirely escape accountability for equally outrageous claims that savers can earn 100%

"interest" on their "accounts."[2] Each promise is illusory; each scheme is identical for labels; each solicitation is equally fraught with peril for the unwary investor.

The Smith opinion, quoting the article by Long, requires that the money invested constitute "risk capital." Certain defendants have argued that the money was not put at risk in the classic

---

[2]If it be objected that the court is indulging in reductio ad absurdum argument, and that no one has ever offered such rates for "notes," it bears reminding that on August 9, 1920, when federal authorities closed the Ponzi operation for mail fraud, a rival concern called the Old Colony Foreign Exchange Co. promised disappointed Ponzi investors 100% interest on six month notes. N.Y. Times, Aug. 10, 1920, at 8. Two days previously, the Massachusetts Attorney General lamented that the Commonwealth had no state law authorizing him to suspend or control Ponzi's affairs. N.Y. Times, Aug. 8, 1920, at 23. Massachusetts passed its Blue Sky law shortly after, on May 27, 1921. Acts 1921, chap. 45[illegible]. Its definition of security included any "note."

sense since the benefit was promised regardless of the success of the venture. This is not the meaning intended by the Smith court.

As Professor Long says in his article:

> The fourth significant common characteristic is a little more subtle. In the case of all generally recognized types of securities, the investment by the investor becomes a part of the capital pool used to conduct the business. Further, whether the investor will receive the benefit which led him to invest initially depends upon the successful employment of this capital....
>
> In the case of bonds or debentures, the capital furnished becomes part of the assets of the venture and the investor is promised two benefits: (1) a certain amount of interest on his money and (2) the eventual return of his investment. Whether these two benefits will in fact occur depends on the successful nature of the business, and the investor rather than the promoter bears all the risk that it may not occur.
>
> It is important to note here that it has not yet been required that the investor acquire an equity interest in the enterprise or that one of the

> benefits offered must be a return of the investment. Clearly in the case of bonds, debentures, or notes no equity interest is given. Instead a debtor-creditor relationship is created. Therefore when we refer to the investment as being a capital contribution, we are using the word "capital" in the broad economic sense rather than the narrow legal meaning of an equity interest in a particular venture.

Ibid. at 167.

A study of Professor Long's article fully persuades us that the Co-op note program lies in the very heartland of transactions intended to be regulated by state legislation. Regardless whether a court adopts a flexible approach, as in Rector-Phillips-Morse, or a more restrictive criminal enforcement-oriented one as in Smith, the Co-op's demand notes are securities.

It is instructive that in dicta, in a case arising out of our district, in the infamous Arkansas Loan & Thrift scandal,

the court indicated that savings accounts were securities for purposes of the federal statute, which the parties suggest is more restrictive than the state law. There the court recited that:

> The record before Judge Miller disclosed that after July, 1965, the defendant AL&T had issued more than four million dollars worth of interest-bearing bond investment certificates, many of them to innocent members of the public who apparently thought they were investing in savings accounts similar to those provided by banks and savings and loan associations.

Securities and Exchange Commission v. Bartlett, 422 F.2d 475, 478 (8th Cir. 1970). The trial court in the same case referred to these "accounts" as securities, saying "The persons whose interest the court has been asked to protect are holders of debt securities issued by the corporations in receivership. The record establishes beyond any doubt that the securities were sold through fraud...."

Securities and Exchange Commission v. Arkansas Loan & Thrift, 294 F. Supp. 1233, 1244 (W.D. Ark. 1969). This latter observation is in response to the suggestion of amicus counsel that demand notes could not be securities since depositions have revealed that the plaintiffs in this case used the notes like bank accounts, adding or withdrawing money whenever they wished. This may be true. That is often true of Ponzi schemes. Certainly, the Co-op advertised the fact that this investment had features much like a bank or savings account.

In summary, the court believes that the demand notes issued by the Farmer's Co-op of Arkansas and Oklahoma, Inc., are "securities" for purposes of the Arkansas Securities Act. The court believes that two considerations unique to Arkansas fully support its conclusion: first is the

legislative history of the act. Before the 1959 Act, all unsecured notes were automatically exempted. After 1959, only "prime" commercial paper enjoyed exemption from the act. For a time, investment programs run by cooperatives enjoyed no exemption. Then, in 1975, the General Assembly flatly exempted all securities other than preferred stock sold to non-members. Evidently, such a broad exemption was unsatisfactory, and in 1977, the General Assembly offered cooperatives a limited exemption for equal voting common stock and membership securities. This amendment imposed a duty to register the demand notes. Finally, in 1979, the legislature offered an exemption to cooperatives for stock and notes issued to members, provided that the cooperative procure an exemption for the issue similar to that required for "non-public

offerings." Ark. Stat. Ann. § 67-1248(e).

The second consideration, unique to Arkansas, which supports our conclusion is that the Arkansas Supreme Court has chosen to follow the "Minnesota Rule," a broad protectionist approach to regulation. In the context of criminal enforcement, where one might expect the statute to be "strictly construed," the court adopted a five-part test formulated by Professor Long, whose explanation of what he meant by "risk capital" and "profit" reinforces our conclusion that notes such as those issued by the Co-op are securities subject to regulatory control, even under the "strictest construction" of the statute.

To the extent that the Arkansas Securities Act borrowed the definition of "security" from the federal Securities Act of 1933 and the Securities Exchange Act of 1934; and to the extent, therefore, that

those seeking relief under the state law are by that token bound to honor federal interpretations of that definition, we are moved to opine that those federal cases holding that certain kinds of "notes" are not "securities" do not succor the defendants in this case. No federal court has ever suggested that a broadscale public offering of notes is a transaction outside the scope of the federal securities acts.

Federal courts are zealous to assure that the Securities Acts of 1933 and 1934 not be construed to admit to federal jurisdiction every kind of commercial transaction gone sour. Because notes are included within the definition of security, the mischievous possibility exists that every time a person or a bank extends a loan to another, and receives his note in return, a federal case is made out if the obligor has failed to register his

"offering" or has inflated his net worth on a financial statement. No one seriously contends that the historic 73rd Congress intended so to trivialize the regulation of securities transactions. Because the statute admits of such a construction, and because it imposes personal liability in cases where parties have lent solely on a corporation's credit, lenders obviously have great incentive to try and exploit the statutes to recover on their loans. To the extent that federal courts allow this to happen, they "open the floodgates," as it were, to bankers embarrassed by defaults. Besides burdening the federal courts with matters not properly of concern to them, such a course of action encourages -- or at least fails to discourage -- imprudent banking practices. Consequently, the federal courts have been loathe to include common commercial transactions within the

reach of the securities laws, and have devised tests which exclude from their ambit those isolated transactions by which a bank or finance company lends money on the security of a debtor, and cannot recover from him when the loan falls due.

One test devised by the federal courts is a so-called "context" test. The federal statutes, like the Arkansas act, hold that defined terms shall have the meaning ascribed to them in the statutes "unless the context otherwise requires." See, e.g., 15 U.S.C. § 77(b); 15 U.S.C. § 78(c); Ark. Stats. Ann. § 67-1247.

In Lino v. City Investing Co., 487 F.2d 689 (3rd Cir. 1973), the court decided that personal promissory notes issued by a private party in partial payment for a franchise did not involve a securities transaction. In its words:

> All of the definitional sections involved in this case are introduced

> by the phrase "unless the context otherwise requires." The commercial context of this case requires a holding that the transaction did not involve a "purchase" of securities. These were personal promissory notes, and the issuer was the person claiming to be defrauded. The notes were not procured for speculation or investment, and there was no indication that [defendant's subsidiary] was soliciting venture capital from Lino.
>
> In no way could City Investing be said to have "purchased" Lino's notes for speculation or investment. City Investing was selling a certain contract right to Lino, not buying his security....
>
> To accept Lino's argument would mean that any consumer who bought an article "on time" and issued a note would be able to sue in a federal court on the theory that the retailer had purchased his security.

The "context" approach presumes that a note is a security, subject to its being excluded from the coverage of the act where a party can show that the underlying transaction was not of the type governed by the securities laws. Courts using the context approach are not spacious in their

explanations of how one determines whether the "context otherwise requires." The general trend, discerned in cases such as Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); Bellah v. First National Bank, 495 F.2d 1109 (5th Cir. 1974); S.E.C. v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); and McClure v. First National Bank, 352 F. Supp. 454 (N.D. Tex. 1973), is to exclude those notes more nearly "commercial" in character, while treating as securities those notes deemed "investments." This approach receives inferential support from dicta in Landreth Timber Co. v. Landreth, [471 U.S. 681], 105 S. Ct. 2297, 2306, 85 L.Ed.2d 692 (1985), which said:

> As we recently suggested ... "note" may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other

> investment context...."

The Landreth Timber Co. dissent expresses similar sentiments, saying:

> I believe that Congress wanted to protect investors who do not have access to inside information and who are not in a position to protect themselves from fraud by obtaining appropriate contractual warranties.
>
> At some level of analysis, the policy of Congress must provide the basis for placing limits on the coverage of the Securities Acts. The economic realities of a transaction may determine whether "unusual instruments" fall within the scope of the Act ..., and whether an ordinary commercial "note" is covered.... The negotiation of an individual mortgage note, for example, surely would not be covered by the Act, although a note is literally a "security" under the definition. Cf. Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 937 (2d Cir.), cert. denied, [469 U.S. 884], 105 S. Ct. 253, [83 L.Ed.2d 190] (1984). The marketing to the public of a large portfolio of mortgage loans, however, might well be.

Landreth Timber Co., supra, 105 S. Ct. at 2312.

If our task is to determine whether the Co-op's notes were issued in the

context of an investment transaction rather than a commercial one, we must recognize that there are no precise tests for making the distinction. We are helped by the fact that in this case the issuer, the Farmer's Co-op, labeled its notes as an "investment." Its monthly newsletters [Plaintiffs' Exhibits, Tab B, Exhibit 2] prominently headlined information about the demand note offering as "Coop Investment Program." In the body of the advertisement the Co-op advertised that the Co-op had more than "$11,000,000 in assets to stand behind your investments. The investment is not Federal Insured but it is ... safe ... secure ... and available when you need it." The directors have alleged that they had nothing to do with the wording of the advertisement; that does not answer the point that under the laws they are answerable for it. If this were a fraud

case, based on misstatements in the newsletter (and in another count not subject to this motion, plaintiffs invoke such a theory), the directors would be presumptively responsible for the wording of the circular, unless they could bear the burden of proving that they justifiably did not know of the existence of the advertising, or that in the exercise of due care they could not have known that it contained factual misstatements. The court does not conceive that the directors claim not to have known that the program for which they are responsible was termed an investment program, even if they personally were not the parties who wrote the newsletter.

In the event that it is insufficient that the Co-op advertised its program as an investment opportunity, and that the directors acquiesced in that

characterization, the way that the Co-op conducted its affairs points even more strongly to the conclusion that the notes were investment instruments, rather than commercial transactions. First, the instruments here in question were issued to a large number of parties. McClure v. First National Bank of Lubbock, 497 F.2d 490, 493 (5th Cir. 1974), cert. denied, 420 U.S. 930, 95 S. Ct. 1132, 43 L.Ed.2d 402 (1973). In the ordinary commercial loan transaction, an applicant approaches one or a small number of lenders and seeks a given amount of capital, frequently collateralizing his request with a greater amount of assets or guaranties. In this case, the Co-op approached its 23,000 members, and non-members as well, with a proposal that they transfer an indeterminate amount of capital to the enterprise, without collateral or insurance

of any kind. More than 1600 members did, allegedly to the tune of more than $10,000,000, and that is why we have a securities question. Even in the absence of precise rules for distinguishing commercial transactions from investments, common sense tells one that his program is not a commercial loan.

In C.N.S. Enterprises, Inc. v. G & G Enterprises, Inc., 508 F.2d 1354, 1361 (7th Cir.), cert. denied, 423 U.S. 825, 96 S. Ct. 38, 46 L.Ed.2d 40 (1975), the court thought it important to consider the relationship between the dollar amount borrowed: the larger the amount relative to the size of the borrower's business, the greater the risk to the lender. The amount of money involved in this issue was quite large, and the extent of the risk has sadly been realized. In this connection, the absence of collateralization is relevant to

a risk analysis since the unsecured lender is much more dependant for repayment on the skills of the borrower than a secured party.

Amicus counsel have asserted that because the instruments in question are demand notes, they are ipso facto not securities, citing Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1257 (9th Cir. 1976). That is a partial abstract of the court's statement, which went on to suggest that demand notes could be considered securities if "payment is dependent on the success of a risky enterprise." Id. Furthermore, the Great Western court said that no single factor determines the question. Id. at 1258. The problem with a mechanical test such as the amicus party would have us apply is that it elevates form over substance; furthermore, it allows the issuer, in this case the Co-

op, to choose a form -- i.e., demand notes -- which evades regulation, while allowing it to substantially practice the very evil which blue sky laws were designed to deter: the broadscale, public solicitation of large amounts of unsecured capital for deployment in a speculative venture. This is all the more dicey an undertaking because of the demand feature of the notes. Because such instruments are susceptible to "runs," the venture which they finance is always at the risk of either rumors of ill fortune attending its own operations, or, conversely, general business reverses in the community of its investors necessitating their withdrawal of capital from the enterprise. Furthermore, the Co-op notes [Plaintiffs' Exhibits, Tab B, Ex. 1] contain no restriction as to the use to which the funds may be put. This further puts the "investor" at risk. The extent

that the issuer is able to put demand note funds into long-term projects as opposed to current operations or inventory, its ability to absorb a run is seriously imperiled. These circumstances impel a conclusion that the Co-op's demand notes are securities, notwithstanding the contention that under other circumstances such an instrument might not be considered an investment.

It bears remarking that cases holding that particular notes were not securities fail to bear any resemblance to the facts of this case. They constituted either loan participations involving banks, or isolated commercial loans involving a limited number of parties with no public offering. For every case holding that notes are not securities, one can find three saying that they are. See generally Lipton & Katz, "Notes" Are Not Always

Securities, 30 Bus. Lawyer 763, 770-71 (1975). See also Promissory Notes as Securities, 39 A.L.R. Fed. 357 (1978). In addition, as we have mentioned, dicta in the district and appeals court decisions in the infamous Arkansas Loan & Thrift scandal of the late 1960's, indicate that an investment scheme almost identical to the one at bar was deemed to involve the issue of securities under federal laws. There appears to be little argument that federal securities law precedents involving promissory notes bar their being considered as securities under the Arkansas statute.

To the extent that such an argument exists, it is based on Securities and Exchange Com. v. W.J. Howey Co., 328 U.S. 293, 66 S. Ct. 1100, 90 L.Ed. 1244 (1946). Howey used a four point test to determine whether a given "investment contract" is a security for purposes of federal

enforcement. "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test is satisfied, it is immaterial whether the enterprise is speculative or nonspeculative...." Id. at 301, 66 S. Ct. at 1104 (emphasis added).

The Co-op itself labeled the transaction an investment. Putting aside any question whether the directors should be bound by that characterization of the program, it bears stunning resemblance to an investment scheme, certainly far more so than it does to a commercial loan. It cannot be gainsaid that tne investment was directed toward a common enterprise. This leaves only the question whether the noteholders expected to receive profits from the efforts of others.

In clearly commercial "contexts,"

the courts have held that interest does not constitute a profit. Kansas State Bank v. Citizens Bank, 737 F.2d 1490, 1495 (8th Cir. 1984). It is broadly contended that anytime the investors "return remains fixed," there can be no profit. That is why it is important to note that Howey declares that it is immaterial that a venture is supposedly "non-speculative" in nature. An instrument is a security under the Howey test if the return, fixed or variable, depends on the managerial efforts of others. To hold otherwise would be to hold that four essential terms of the statutory definition of security -- "note," "bond," "debenture" and "evidence of indebtedness" -- are to be judicially written out of the coverage of the laws. This would mean that the very kind of instrument used by Mr. Ponzi to such great effect, a short term, uncollateralized

note, could entirely escape regulation. It would be irony indeed that Ponzi, whose machinations contributed so greatly to the development of securities laws in this country, should find his note-based scheme practically the only one not controlled by the laws he made so needful in the first place. Reading the arguments of the defendants, he might be encouraged to set up shop in the old stand again, no doubt relishing that his Securities Exchange Company, by a quirk of law, escapes oversight by the Securities Exchange Commission.

This court is confident that no American lawmakers, state or federal, intended so unseemly a result. Given Arkansas's bitter experience with the Arkansas Loan & Thrift scandals, an "issue" which surfaced again in the most recent gubernatorial primary, it is inconceivable

that the General Assembly would have intended not to regulate the very kind of scheme which had so embarrassed the government less than a generation ago. On the record presented, the Co-op's demand notes are securities, which, from April 5, 1980, until October 28, 1984, were neither registered nor exempt.

B. <u>The Knowledge Issue</u>

[Remainder of text omitted].

An order summarizing these findings will be issued contemporaneously herewith.

15 U.S.C. § 78c(a)(10)

(a) When used in this chapter, unless the context otherwise requires --

* * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or

privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

OPPOSITION

BRIEF

Supreme Court, U.S.
FILED
MAR 31 1989
JOSEPH F. SPANIOL, JR.
CLERK

(2)

No. 88-1480

IN THE
Supreme Court of the United States
OCTOBER TERM, 1988

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, as Representatives of a Class of Note Holders,

Petitioners,

v.

ARTHUR YOUNG & CO.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF ARTHUR YOUNG & COMPANY IN OPPOSITION TO PETITION FOR A WRIT OF *CERTIORARI*

John Matson
(Counsel of Record)
Carl D. Liggio
Elizabeth B. Healy
Jacqueline B. Steele
277 Park Avenue
New York, NY 10172
(212) 407-2358
Kathryn A. Oberly
2000 Pennsylvania Ave., N.W.
Washington, D.C. 20006
Michael H. Mashburn
P.O. Box 1921
Fayetteville, AR 72702

Attorneys for Respondent

291

TABLE OF CONTENTS

Page

STATEMENT OF THE CASE 1

THE DEMAND NOTES 2

THE ROLE OF ARTHUR YOUNG 2

THE CASE BELOW 3

ARGUMENT 6

I. THE DEMAND NATURE OF THE NOTES MAKES THIS AN INAPPROPRIATE CASE FOR RESOLVING WHEN A NOTE IS A SECURITY 7

II. THE COURTS OF APPEALS SHOULD HAVE THE OPPORTUNITY TO APPLY THE *LANDRETH* DECISION TO PROMISSORY NOTES 11

III. PETITIONERS HAVE MADE NO EFFORT TO SHOW THAT SUPREME COURT INTERVENTION IN THE "NOTE" ISSUE IS NECESSARY 12

A. The Different Methodologies Used By The Circuits In Note Cases Have Not Produced Divergent Results 13

B. The Eighth Circuit's Analysis Of The Fixed Rate of Interest Issue Is Consistent With That Of Other Circuits ..16

CONCLUSION 19

APPENDIX.....A.1

Form of the Demand Notes.....A.1

TABLE OF AUTHORITIES

Page

Cases

American Bank & Trust Co. v. Wallace, 702 F.2d 93 (6th Cir. 1983).....15-16

American Fletcher Mortgage Co. v. U.S. Steel Credit Corp., 635 F.2d 1247 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981).....17, 18

Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986) 5

Chiarella v. United States, 445 U.S. 222 (1980)..... 5

C.N.S. Enterprises, Inc. v. G.&G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).....15

Danner v. Himmelfarb, 858 F.2d 515 (9th Cir. 1988).....12

E.I. du Pont de Nemours & Co. v. Train, 430 U.S. 112 (1977).....12

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).....10, 12

Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976).....10, 14

Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230 (2d Cir. 1985).....17, 18

Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976).....9, 10, 13-14

Page

Hunssinger v. Rockford Business Credits, Inc., 745 F.2d 484 (7th Cir. 1984) 8, 17, 18

Kansas State Bank v. Citizens Bank, 737 F.2d 1490 (8th Cir. 1984).....16

Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985)..... *passim*

Marine Bank v. Weaver, 455 U.S. 551 (1982).....16

McVay v. Western Plains Serv. Corp., 823 F.2d 1395 (10th Cir. 1987) 17

SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970) 9

SEC v. W.J. Howey Co., 328 U.S. 293 (1946)..... *passim*

SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976).....8, 17, 18

Underhill v. Royal, 769 F.2d 1426 (9th Cir. 1985)..... 8

Union Nat'l Bank v. Farmers Bank, 786 F.2d 881 (8th Cir. 1986) 16

Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981) 17

United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975).....6, 16

Page

Windon Third Oil & Gas Drilling Partnership v. FDIC, 805 F.2d 342 (10th Cir. 1986), *cert. denied*, 480 U.S. 947 (1987)..... 5

Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974).....14

Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973)..... 8

STATUTES AND REGULATIONS

Arkansas Securities Act § 67-1256..... 4

Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*..... 9

Securities Act of 1933, 15 U.S.C. § 77l..... 4

Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10).....9, 10, 14
15 U.S.C. § 78j(b).....4, 12

Securities & Exchange Comm'n, Regulation S-X, Rule 6-04.5, 17 C.F.R. § 210.6-04.5..... 9

Page

OTHER AUTHORITIES

Comment, *Commercial Notes and Definition of "Security" Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 NEB. L. REV. 478 (1973) 8, 14-15

Jones, *Footnote 11 of Marine Bank v. Weaver: Will Unconventional Certificates of Deposit Be Held Securities?*, 24 HOUS. L. REV. 491 (1987).....16

Lizzul, *The Evolution of Bank Term Lending and the Status of Term Notes under the Federal Securities Laws*, 31 SYRACUSE L. REV. 959 (1980) 9

Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934, 36 MD. L. REV. 233 (1976) 15

WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934).....10

No. 88-1480

IN THE
Supreme Court of the United States
OCTOBER TERM, 1988

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, as Representatives of a Class of Note Holders,

Petitioners,

v.

ARTHUR YOUNG & CO.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF ARTHUR YOUNG & COMPANY IN OPPOSITION TO PETITION FOR A WRIT OF *CERTIORARI*

STATEMENT OF THE CASE

Farmers Co-Op of Arkansas and Oklahoma (the "Co-Op") was, in most respects, indistinguishable from the thousands of other agricultural co-operatives across rural America. However, unlike others, it borrowed from its members and gave them promissory notes payable on demand. By doing so, it achieved lower interest costs than it would have incurred through borrowings from banks, larger co-operatives and other lending sources and, at the same time, its members realized a higher rate of return than they could have obtained as depositors at local banks and savings institutions. The Eighth Circuit held that the

demand notes were not securities, *Arthur Young & Co. v. Reves*, 856 F.2d 52 (8th Cir. 1988), Pet. App. A.8, and this petition for *certiorari* followed.

THE DEMAND NOTES

The demand notes, a copy of which is reprinted in the Appendix to this brief, were simple instruments, more like deposit slips than the elaborate notes sometimes used to evidence investments. Interest was payable at a fixed rate, although in practice the rate was pegged just above that being paid at a given time by local banks and savings institutions.

Many members used the demand note program like a passbook savings account, making frequent "deposits" and periodically "withdrawing" portions of their funds. Others left their funds in the program to accumulate interest, as they would if they were using a savings and loan association or a commercial bank. When a noteholder deposited additional funds, he or she received a new note and, when funds were withdrawn, the existing note was returned to the Co-Op and replaced with one reflecting the balance left after the withdrawal.

THE ROLE OF ARTHUR YOUNG

Arthur Young, a national partnership of certified public accountants, audited the Co-Op's 1981 and 1982 financial statements and issued its reports on those statements to the Co-Op's management and board of directors. Prior auditors had permitted most of the demand notes to be classified as long-term liabilities and had required only a small portion to be classified as short term. Arthur Young refused to accept that treatment because all of the demand notes could be presented for payment at any time.

Management reluctantly acquiesced and showed all the demand notes as current liabilities on the Co-Op's 1981 and 1982 financial statements.[1] Arthur Young also urged the Co-Op's management and directors to reduce its dependence on demand notes but that advice was ignored.

In addition, Arthur Young required extensive other new disclosures by the Co-Op in its financial statements and, even with that, issued to the Co-Op management and board heavily qualified audit reports. Despite Arthur Young's suggestions to the Co-Op board of directors, the financial statements audited by Arthur Young were never disseminated to Co-Op members.[2] The only financial information any members received were condensed financial statements prepared by the Co-Op's management and circulated only to the 350 or so members who attended the Co-Op's annual meetings. There was no evidence that anyone who attended those meetings thereafter participated in the demand note program.

THE CASE BELOW

Early in 1984 the Co-Op filed for protection under the federal bankruptcy laws. At that time approximately 7% of its 23,000 members held demand notes that aggregated approximately $10,000,000. In early 1985 the trustee in bankruptcy and a class of

---

1 The 1982 Co-Op financial statements, together with Arthur Young's audit report on them, have been lodged with the Clerk of this Court.

2 Although its bylaws stated that the Co-Op would distribute audited financial statements to its members, there was apparently no requirement under Arkansas law that any financial information be furnished to Co-Op members.

noteholders filed suit against scores of persons and entities, including Arthur Young. Dozens of federal and state law claims were asserted, including several under federal and state securities law theories. Although, at least as to Arthur Young, most of the claims were eventually dismissed or disposed of on summary judgment, the trial court declined to dismiss the securities law claims despite Arthur Young's argument, *inter alia*, that the demand notes were not securities and thus that no securities law claims could be asserted.

Although the claims against most defendants were settled, with the class recovering approximately $5,775,000 in that manner, the case was tried as to Arthur Young on several common law claims asserted by the trustee and on the class claims under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (the "1934 Act"), and section 67-1256 of the Arkansas Securities Act, which was modeled after section 12 of the Securities Act of 1933, 15 U.S.C. § 77l (the "1933 Act"). Arthur Young prevailed on the trustee's claims and the class prevailed on its claims against Arthur Young, receiving a $6,100,000 rescission verdict that was reduced to approximately $375,000 by credits for the settlement payments the class had received.

All parties appealed, with Arthur Young raising a series of very serious errors, including the trial court determination that the demand notes were securities.[3] The Eighth Circuit did not have to reach

---

[3] The most striking of the other trial court errors was its permitting the class claim under section 10(b) to go to the jury despite the fact that no information emanating from Arthur Young was ever communicated to the class, most of whose

any of the other issues raised by Arthur Young because, using an analysis based on *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), it concluded that the demand notes were not securities under either federal or state law and could not support the securities fraud claims asserted against Arthur Young. Pet. App. A.17-25.

In *Landreth*, this Court held that, where "traditional stock" was at issue, its status as a security could be established from its name and characteristics. Although it reserved decision with respect to notes or other instruments, the Court suggested that the test derived from its decision in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), would apply to an instrument that did not have both a statutorily enumerated name -- stock, bond, note, debenture -- and the characteristics of a security.[4] Applying *Landreth* to the demand notes in this case, the Eighth Circuit determined that, although they had a name -- notes -- traditionally associated with a security, they did not have all the characteristics of a security because of their demand nature. Pet. App. A.20-21. Under the *Landreth* approach, the Eighth Circuit then applied the *Howey* test and concluded that its criteria were not satisfied because the transactions evidenced by the demand notes were more like loans

---

members had apparently never heard of Arthur Young, and the fact that, not being a fiduciary to the class, Arthur Young had no duty to communicate with the class members. *See, e.g., Chiarella v. United States*, 445 U.S. 222 (1980); *Windon Third Oil & Gas Drilling Partnership v. FDIC*, 805 F.2d 342 (10th Cir. 1986), *cert. denied*, 480 U.S. 947 (1987); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986).

[4] The *Howey* test requires a determination whether, in light of "the economic realities, the transaction 'involve[d] an investment of money in a common enterprise with profits to come solely from the efforts of others.'" *Landreth*, 471 U.S. at 689, quoting *Howey*, 328 U.S. at 301.

than investments and because the fixed interest rate of the notes did not evidence an anticipation of profit as this Court had used that phrase in *Howey* and later in *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975). Pet. App. A.22-23.

The Eighth Circuit held:

> Because these demand notes were uncharacteristic of securities, and also failed the *Howey* test, we conclude that they were not securities within the meaning of the Federal Act. The Class has thus failed to state a claim under section 10(b) of the Federal Act, 15 U.S.C. § 78j(b).

Pet. App. A.23. The class' petition for rehearing *en banc* was denied by a six to four vote of the Eighth Circuit. *Id.* at A.1-7.[5]

ARGUMENT

The decision of the court of appeals is correct and does not warrant this Court's review. Indeed, the most striking aspect of the petition is its failure even to attempt to demonstrate that the question whether demand notes constitute "securities" under the 1934 Act has any significance beyond the confines of this case. Demand notes are uncommon and only rarely are the courts called upon to consider their treatment under the federal securities laws. Not surprisingly, therefore, petitioners are unable to cite a single decision in which a court of appeals has held that

---

5 Judge Sneed of the Ninth Circuit was a member of the panel in this case but, of course, did not vote on the rehearing petition.

instruments of the type here at issue are securities. Should the demand note question arise again, there will be time enough for the Court to visit the issue in another case.

In the meantime, petitioners' assertion of a conflict among the circuits rings hollow. Most of the supposed conflicts involve term notes -- instruments payable at a future date -- that are very different from the demand notes here. Although the courts of appeals do apply different analytical methodologies to determine whether a particular note qualifies as a security, there is no significant difference in result. As a practical matter, therefore, there is no need for this Court's intervention.

I.

THE DEMAND NATURE OF THE NOTES MAKES THIS AN INAPPROPRIATE CASE FOR RESOLVING WHEN A NOTE IS A SECURITY

The critical feature of the notes in this case was that they were payable on demand. This characteristic, which was pivotal to the court of appeals' decision that the notes were not securities, is rarely seen in note cases. This is hardly surprising because the demand feature is so antithetical to securities treatment that few such cases are ever litigated. Indeed, the entire body of federal case law on this subject is limited to a handful of cases. More importantly, the Eighth Circuit's decision in this case is the only circuit opinion to consider expressly the note-as-a-security issue in the context of instruments

whose predominant feature is their demand characteristic.[6]

As the court of appeals recognized, the noteholders' ability to obtain their money on "demand" is a feature "very uncharacteristic of a security." Pet. App. A.21.[7] The fundamental distinction between demand notes and other promissory notes lies in the instant liquidity of demand notes. This feature also distinguishes demand notes from securities of all types

---

6 Petitioners cite only one court of appeals decision in which it is even arguable that a demand note -- albeit one very different from those at issue here -- was held to be a security. *See Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973), cited in the Petition at 6 n.8. The *Zeller* court's characterization of the instrument at issue in that case as a "demand note" seems questionable in light of the court's observation that "the maker of the note [the parent of the holder] *could prevent any demand* by the holder. . . ." 476 F.2d at 799 (emphasis added). Even assuming that the note was a true demand note, the opinion contains no analysis of the effect of the demand feature on the question whether the note should be treated as a security. The flaws in *Zeller* are analyzed in Comment, *Commercial Notes and Definition of "Security" Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 NEB. L. REV. 478, 522 n.166 (1973). The other appellate cases cited by petitioners (at 6-7 nn.8 & 9) involved one-year term notes (*Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984)); call provisions (*Underhill v. Royal*, 769 F.2d 1426 (9th Cir. 1985) (notes with one to three year maturities; allegations that the notes were callable but no indication when during their term that could occur)); and ninety-day acceleration clauses (*SEC v. World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976)).

7 Indeed, a demand feature may be indicative of a security only in precisely the opposite situation from the case presented here: "[W]hen a 'demand' provision is embodied in a *security*, it is generally a demand on the part of the issuer, not the holder, as with securities subject to call or redemption provisions at the option of the issuer." Comment, *Commercial Notes and Definition of "Security" Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 NEB. L. REV. 478, 522 (1973).

because instant liquidity is incompatible with either a time commitment or a sense of risk, both of which are inherent in the concept of "investment." *See generally* Lizzul, *The Evolution of Bank Term Lending and the Status of Term Notes under the Federal Securities Laws*, 31 SYRACUSE L. REV. 959, 1005-06 (1980).[8]

In recognizing the importance of liquidity to its analysis of this case, the Eighth Circuit followed the approach of the Ninth Circuit, which, in *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1257-58 (9th Cir. 1976), a ten-month-note case, said, "A demand or short term note is almost *ipso facto* not a security unless payment is dependent upon the success of a risky enterprise or the parties contemplate indefinite extension of the note or perhaps conversion to stock."[9] As the Eighth Circuit noted, those conditions were not present in the demand notes before it.

---

8 In the slightly different context of the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, the Securities and Exchange Commission defines "cash" as "cash on hand and demand deposits." Securities & Exchange Comm'n, Regulation S-X, Rule 6-04.5, 17 C.F.R. § 210.6-04.5 (1988). This appears comparable to the 1934 Act *exclusion* from the definition of a security of "currency or any note, draft bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months. . . ." 1934 Act § 3(a)(10). Pet. App. A.82. If, as has been held, certificates of deposit are not securities for purposes of the predecessor of Rule 6-04.5, *see SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970), these demand notes should not be securities under the 1934 Act.

9 *Kotz* also demonstrates that the dissent to the denial of rehearing was simply wrong when it said that the panel decision "appears to commit the Eighth Circuit to a definition of security unique among the federal courts." Pet. App. A.3.

In any event, most notes are term notes, and it is plainly term notes that Congress had in mind when it included "notes" within the coverage of the federal securities laws. *See* 1934 Act § 3(a)(10) (excluding currency and notes with maturities of nine months or less). In this respect, it is appropriate to examine contemporary dictionary definitions of the relevant terms. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 nn.20-21 (1976) (relying on WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934)). WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934) defines "demand note" separately from other "notes." *Compare id.* at 694 *with id.* at 1668.

Because demand notes are so rare and so different from term notes, the case law concerning promissory notes involves almost exclusively the latter. In those decisions, the length of the term and its relationship to other facets of the transaction are often critical to the outcome of the case. *See, e.g., Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976); *Great Western Bank & Trust v. Kotz*, 532 F.2d at 1257-58. The Court should therefore decline petitioners' invitation to fashion a rule of law for the treatment of "notes" under the securities laws in the context of a case involving instruments that are fundamentally different in character from the term notes that comprise the body of note-as-a-security litigation in the lower courts.

II.

THE COURTS OF APPEALS SHOULD HAVE THE OPPORTUNITY TO APPLY THE *LANDRETH* DECISION TO PROMISSORY NOTES

The *Landreth* decision represents an important milestone in this Court's jurisprudence on the interpretation of the phrase "security" in the 1933 and 1934 Acts. Recognizing that its prior decisions were less than clear, 471 U.S. at 688, the Court synthesized those decisions and, at least with respect to instruments labelled "stock," developed a clear and easily applied three-step test. The Court specifically declined to extend that test to a subject not before it -- promissory notes -- but it, in fact, discussed only two tests in its *Landreth* decision: the one it derived for stock and the *Howey* test, which focuses on whether there was "an investment of money in a common enterprise with the profits to come solely from the efforts of others." 471 U.S. at 689, quoting *Howey*, 328 U.S. at 301. That is suggestive that, in the note context, the applicable test is either *Howey* or the one developed in *Landreth*.

In the case below, the court considered both tests and concluded that the demand notes were not securities under either. We suggest that the principles of *Landreth* are fully applicable to promissory notes and that the *Landreth* test can be applied with only one minor variation -- instead of analyzing an instrument in terms of the characteristics of traditional stock, as the Court did in *Landreth*, the courts would make the analysis in terms of the characteristics of a note that qualifies as a security.

Since *Landreth* the courts of appeals have had very little opportunity to consider the applicability of the test developed in that case to the note issue.[10] The circuits should be given the opportunity to develop the *Landreth* framework in this context before this Court is asked to decide upon an approach for determining when a note is a security. *See, e.g., E.I. du Pont de Nemours & Co. v. Train*, 430 U.S. 112, 135 n.26 (1977) (noting the "wisdom of allowing difficult issues to mature through full consideration by the courts of appeals" prior to Supreme Court review).

III.

PETITIONERS HAVE MADE NO EFFORT TO SHOW THAT SUPREME COURT INTERVENTION IN THE "NOTE" ISSUE IS NECESSARY

In some areas of interpretation under the federal securities laws, the different approaches of the courts of appeals have produced such jarringly disparate results that intervention by this Court is necessary. One clear example relates to the fault standard under section 10(b) of the 1934 Act. Prior to the Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), some courts of appeals applied a negligence standard and some a scienter standard. For many cases the choice of a circuit determined whether the case would survive a dismissal motion. That kind of situation required resolution by this Court. The same cannot be said about the issues

---

[10] In *Danner v. Himmelfarb*, 858 F.2d 515 (9th Cir. 1988), the Ninth Circuit noted *Landreth* but applied the risk capital test in concluding that the four-year term promissory notes before it were not securities.

raised by petitioners. They, in fact, do not even attempt to identify any compelling policy issues at stake or any irreconcilable conflicts that must be resolved.

A. The Different Methodologies Used By The Circuits In Note Cases Have Not Produced Divergent Results.

All petitioners have done in their effort to portray conflict among the courts of appeals is to point out different approaches in the circuits to the issue of whether a particular term note is a security. However, those differences are in methodology, not in results. Significantly, petitioners themselves recognized as much when they told the Eighth Circuit that "the outcome would not differ" under the commercial/investment, "literal" or risk capital tests. Petition for Rehearing at 10 (footnote omitted). Petitioners' statement to the court of appeals was correct and they have offered no justification for their about-face in this Court.

A consumer mortgage would be held not to be a security whether the commercial/investment, risk capital, "literal" or *Landreth* test were applied. Similarly, a widely-distributed issue of long-term promissory notes by a public company would be held to be a security under any of the tests. Petitioners have not even demonstrated that the demand notes at issue here would be held to be securities under any of the various tests. As indicated above, the Ninth Circuit, which applies the risk capital test, has ruled that a demand note "is almost *ipso facto* not a security. . . ." *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252,

1257-58 (9th Cir. 1976).[11] Moreover, having the right to a return of one's funds on demand is the antithesis of placing one's capital at risk through the efforts of others. Similarly, petitioners acknowledge, at pages 4-5 of the Petition, that, under the "literal" test, an instrument with less than nine months' maturity is presumptively not a security. *See Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137-38 (2d Cir. 1976).[12]

Finally, under at least one version of the commercial/investment test, which petitioners argue should be adopted by the Court, demand notes would clearly not be securities. In *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974), the court, after noting that "[m]aking the distinction between commercial and investment notes when proceeds are to be used for a business purpose is often difficult," *id.* at 551, applied the following test: "whether the transaction is of the kind in which stock often actually *is* given." *Id.*, quoting Comment, *Commercial Notes and Definition of*

---

[11] Petitioners argue that this case falls within an exception in *Kotz* because "the Co-Op was a risky enterprise." Pet. at 6 n.8. This ignores the fact that demand notes were used by the Co-Op for 25 years and that payment, being available upon demand, did not depend on the profitability of the enterprise. Further, by so arguing, petitioners appear to concede that, where an instrument does not have the characteristics of a security, *e.g.*, where it is payable on demand, external factors, such as riskiness, determine whether the instrument is a security. This approach is merely a variation of the *Howey* test and does not present any issue worthy of this Court's review.

[12] The presumption arises from the definition of a security in section 3(a) of the 1934 Act, which provides in pertinent part that "unless the context otherwise requires . . . (10) The term 'security' means any note . . . but shall not include currency or any note . . . which has a maturity at the time of issuance of not exceeding nine months. . . ." Pet. App. A.82.

"Security" Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?, 52 NEB. L. REV. 478, 501 (1973) [hereinafter *Nebraska Comment*] (emphasis in original). Under that version of the commercial/investment test the demand notes here would surely not be securities because stock is not often given in instances where an instrument is payable on demand or where funds are frequently "deposited" and "withdrawn."

Even under the version of the commercial/investment test advanced by petitioners, *see* Pet. at 4, it is doubtful that demand notes would be held to be securities. The purpose of that test is to determine if an investment has been made, *C.N.S. Enterprises, Inc. v. G.&G. Enterprises, Inc.*, 508 F.2d 1354, 1359 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *see also Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 MD. L. REV. 233, 243 & n.46 (1976). The instant liquidity inherent in demand notes is totally foreign to the concept of "investment" and the author of the criteria used under that version of the commercial/investment test has emphasized that a demand feature in a note is an indication that it is not a security. *Nebraska Comment* at 521-23.

This is not to say that there will never be any variation among the courts of appeals but it does show that the disparity among the circuit decisions is not of such a magnitude that the Court needs to intervene at this time. The unanimity of result, if not approach, was summed up by the Sixth Circuit: "The circuits are split with respect to the analysis to be applied in defining a 'security,' although the results reached under the various suggested tests are virtually identical." *American Bank & Trust Co. v. Wallace*,

702 F.2d 93, 95 (6th Cir. 1983). *See* Jones, *Footnote 11 of Marine Bank v. Weaver: Will Unconventional Certificates of Deposit Be Held Securities?*, 24 HOUS. L. REV. 491, 507-08 (1987).

B. The Eighth Circuit's Analysis Of The Fixed Rate of Interest Issue Is Consistent With That Of Other Circuits.

Petitioners also argue that the Eighth Circuit is at odds with other circuits in construing the third element of the *Howey* test -- "reasonable expectation of profits" -- to require "'capital appreciation . . . or a participation in earnings . . .,'" Pet. App. A.22, quoting *Kansas State Bank v. Citizens Bank*, 737 F.2d 1490, 1495 (8th Cir. 1984), and *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975), and in holding that this requirement is not satisfied where interest is payable at "an established market rate." *See* Pet. at 6.[13]

[13] Petitioners ignore the other ground on which the Eighth Circuit found *Howey* was not satisfied: that the notes were not an "investment" under the first *Howey* element because the Co-Op initiated the demand note program so "it could obtain funds at rates lower than those offered by banks [and] the members 'deposited' their money with the Co-Op in order to earn a higher return than could be obtained from a bank." Pet. App. A.22. Even if petitioners were correct in their argument that the right to interest reflects a "reasonable expectation of profit" under the third element of the *Howey* test, application of the "investment" requirement in the first element would defeat treatment of the demand notes as securities.

Petitioners also claim that the court of appeals "ignores" their argument that the demand notes must be securities because of "the enormous scale and duration" of the demand note program. Pet. at 7. The circuit court, in fact, spoke to that point when it noted Congress' "intent not to provide a broad federal remedy for all fraud. . . ." Pet. App. A.19, quoting *Union Nat'l Bank v. Farmers Bank*, 786 F.2d 881, 884 (8th Cir. 1986). *Accord Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

This approach is the predominant one where, as here, the *Howey* test is applied to an instrument without both the name and characteristics of a security. *See, e.g., McVay v. Western Plains Serv. Corp.*, 823 F.2d 1395, 1399 (10th Cir. 1987); *Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1184-85 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981); *American Fletcher Mortgage Co. v. U.S. Steel Credit Corp.*, 635 F.2d 1247, 1254 (7th Cir. 1980), *cert. denied*, 451 U.S. 911 (1981).

Moreover, the circuit cases that petitioners cite are not inconsistent with this approach. *SEC v. World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976), cited in the Petition at 6-7 n.9, does not even discuss the impact of a fixed rate of interest on the question whether a note is a security. *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985), which petitioners cite at 6-7 n.9, involved certificates of deposit collected, packaged and sold as highly-negotiable units by Merrill Lynch. Thus, much more was involved in *Gary Plastic* than the simple fixed rate of interest that was present in the demand notes in this case.

In *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984), cited in the Petition at 6-7 n.9, the court held only that the presence of a fixed rate of interest was not, by itself, determinative that a note was not a security. *Id.* at 491. That is not at odds with the holding below that, for reasons unrelated to the interest rate feature, the demand notes did not have the characteristics of a security. The clear import of *Hunssinger* is that, if the notes there had not possessed all the characteristics of a security and the *Howey* test had been applied, the interest rate feature would have caused the notes to fail that test. *Id.* at 491-92.

See American Fletcher Mortgage Co. v. United States Steel Credit Corp, 635 F.2d at 1254, *discussed in Hunssinger*, 745 F.2d at 489-90. This is entirely consistent with the Eighth Circuit's decision in this case.

In short, where an instrument does not possess both the name and characteristics of a security, it is appropriate that a court consider whether the interest-bearing nature of the instrument satisfies the "reasonable expectation of profit" element of the *Howey* test. In *World Radio Mission* the issue was never even discussed; in *Hunssinger* there was no need to reach the question; and in *Gary Plastic*, on facts very different from those here, that test was satisfied. Nothing in those decisions is at odds with the decision below or the many other circuit cases holding that the right to a fixed rate of interest does not evidence a "reasonable expectation of profit" under *Howey*. *See supra* at 16-17.

CONCLUSION

For the reasons stated above, the petition for a writ of *certiorari* should be denied.

New York, New York
March 31, 1989

Respectfully submitted,

John Matson
(Counsel of Record)
Carl D. Liggio
Elizabeth B. Healy
Jacqueline B. Steele
277 Park Avenue
New York, NY 10172
(212) 407-2358

Kathryn A. Oberly
2000 Pennsylvania Ave., N.W.
Washington, D.C. 20006

Michael H. Mashburn
P.O. Box 1921
Fayetteville, AR 72702

Attorneys for Respondent

APPENDIX

Ex. to

No.

Due On Demand

March 29, 1976

On Demand after date, for value received, I, we, or either of us, promise to pay to the order of

Joe S. Hester Executor-Estate of J. C. Hester

$ 4,000.00

Cr.

Bal.

Four Thousand Dollars and 00/100---------- DOLLARS,

negotiable and payable without defalcation or discount at Van Buren, Arkansas with interest from Date until paid, at the rate of 6% per cent, per annum; and if not paid when due, the interest is to become part of principal and bear a like rate of interest. No extension of time of payment with or without our knowledge, by receipt of interest or otherwise, shall release us, or either of us, from the obligation of payment. The makers and endorsers of this note hereby waive demands, notice and protest, and in event payment is not made at maturity, we further agree to pay attorney fees incurred in enforcing the collection of this note, or any part of it.

All accrued interest payable Comp. Quarterly monthly and annually thereafter.

P. O. Rt. #4, Box 653C

P. O. Muskogee, OK 74401

Farmers CO/OP of Ark. & Okla.

Jack E. White by Richard Brewer

JACK F. WHITE, Manager

REPLY

BRIEF

Supreme Court, U.S.
FILED
APR 20 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-1480

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1988

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, As Representatives of a Class of Note Holders,

Petitioners,

v.

ARTHUR YOUNG & CO.

Respondent.

REPLY SUPPORTING PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Gary M. Elden
(Counsel of Record)
John R. McCambridge
Jay R. Hoffman
Grippo & Elden
Attorneys for Petitioners
20 South Clark Street
Chicago, Illinois 60603
(312) 704-7700

TABLE OF CONTENTS

	Page
TABLE OF CONTENTS.....	i
TABLE OF AUTHORITIES.....	ii
ARGUMENT IN REPLY.....	1
I. The Eighth Circuit Created A Serious Enforcement Problem When It Excluded Demand Notes Offered To The General Public From Federal and State Securities Regulation.....	1
II. The Four Different Note Tests Used In The Circuits Produce Inconsistent Results, And This Court Should Resolve This Long-Standing Conflict Now...	7
CONCLUSION.....	12
APPENDIX.....	A-1
1. Securities and Exchange Commission Amicus Brief on Rehearing.....	A-1
2. March 23, 1989 Letter of Mr. Lee Polson, Executive Director of the North American Securities Administrators Association...	A-15
3. Co-Op Investment Program Advertisement.....	A-18

TABLE OF AUTHORITIES

Cases	Page
Baurer v. Planning Group, Inc., 669 F.2d 770 (D.C. Cir. 1981)....	8
Futura Dev. Corp. v. Centex Corp., 761 F.2d 33 (1st Cir.), cert. denied, 474 U.S. 850 (1985).....	11
Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976)....	9
Hunssinger v. Rockford Business Credits, Inc., 745 F.2d 484 (7th Cir. 1984).....	8
Johnson v. Computer Technology Services, 670 F. Supp. 1036 (D.D.C. 1987)..	8
McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975).....	8, 10
SEC v. White, No. CA 86-2015 (W.D. Ark. 1986), Lit. Release No. 11,066 (Apr. 17, 1986), 35 SEC Docket 874; Lit. Release No. 11,087 (May 1, 1986), 35 SEC Docket 1076.....	3
Underhill v. Royal, 769 F.2d 1426 (9th Cir. 1985)....	8

United States v. Farris,
614 F.2d 634 (9th Cir. 1979),
cert. denied, 447 U.S. 926 (1980) 8

Other Authorities

Lizzul, The Evolution of Bank
Term Lending and the Status
of Term Notes Under the
Federal Securities Laws,
31 Syracuse L. Rev. 959 (1980)... 11

L. Loss, Fundamentals of
Securities Regulation (1988)..... 9

ARGUMENT IN REPLY

I. The Eighth Circuit Created A Serious Enforcement Problem When It Excluded Demand Notes Offered To The General Public From Federal And State Securities Regulation.

Respondent Arthur Young & Co. ("AY") argues that demand notes are uncommon and that the Eighth Circuit's decision has no significance beyond this case. (AY Brief at 5.) The Class does not agree. More significantly, the Securities and Exchange Commission, the Arkansas Securities Department, and the North American Securities Administrators Association all disagree with AY. Federal and state securities regulators have taken the position that the court of appeals decision is incorrect, and, if allowed to stand, will severely handicap their efforts to protect the investing public from future fraudulent note offerings. The Class

respectfully suggests that this Court request the views of the United States to determine if the Eighth Circuit has created a serious problem in the administration and enforcement of the federal and state securities laws.

The Securities and Exchange Commission ("SEC") for years has actively sought to protect the interests of the Co-Op's noteholders. The SEC brought an enforcement action against the sellers of the Co-Op demand notes that alleged violations of the registration and antifraud provisions of the federal securities laws. The SEC's case ended in 1986 with the entry of consent

injunctions.[1]

The SEC became interested in this private action when the court of appeals panel decided that the Co-Op's demand notes issued through the "Coop Investment Program" were not securities under the federal or state acts. The panel effectively prohibited the SEC, in at least seven states, from regulating note offerings similar to the Co-Op's. On rehearing, the SEC filed an amicus brief in support of the Class and stated its view that the Co-Op's demand notes are securities under the federal acts. (The SEC's brief is reproduced in the Appendix to this Reply at A-1.)

---

[1] See SEC v. White, No. CA 86-2015 (W.D. Ark. 1986), Lit. Release No. 11,066 (Apr. 17, 1986), 35 SEC Docket 874; Lit. Release No. 11,087 (May 1, 1986), 35 SEC Docket 1076.

State authorities share the SEC's concern. The Arkansas Securities Department, which had regulated the Co-Op's investment program, also filed an amicus brief in support of the Class' petition for rehearing. It argued that if the panel decision were allowed to stand, the Department could not protect its state's citizens from the similar fraudulent schemes that the decision was bound to encourage.

After the Eighth Circuit narrowly denied the Class' petition for rehearing, other states' regulators have agreed that the decision will create serious enforcement problems. Most notably, the North American Securities Administrators Association ("NASAA") joined the SEC in opposing the court of appeals decision. According to the NASAA, "[I]n recent years

a number of fraudulent schemes prosecuted by states have involved sales of investment notes virtually identical to the notes involved in Reves. . . . State securities officials are vitally interested in the outcome of this case, and they fear the damage that may be done to law enforcement programs if the Eighth Circuit decision is allowed to stand." (The March 23, 1989 letter of Mr. Lee Polson, Executive Director of the NASAA, is reproduced at A-15.)

The strongly negative reaction of federal and state securities regulators to the Eighth Circuit's decision proves its significance. Fraudulent schemes identical to the Co-Op's, which the SEC and the State of Arkansas tried to regulate, will now go unchecked in at least seven states. Mr. Ponzi used 45-day notes to defraud his

investors; his followers in the Eighth Circuit would be well-advised to use notes payable on demand. (One of the Co-Op's many advertisements of investment notes is reproduced at A-18.)

AY also argues that the Eighth Circuit's decision is consistent with precedent in the other courts of appeals, and that demand notes offered to the general public as investments are not securities in any state. If AY is correct, the problem this case exemplifies is that much more severe. The Class therefore urges this Court to address the concerns of the federal and state agencies who enforce the securities laws by granting the writ. If the Court has any doubts about the significance of this case, the Class respectfully suggests that the Court request the views of the United States.

II. The Four Different Note Tests Used In The Circuits Produce Inconsistent Results, And This Court Should Resolve This Long-Standing Conflict Now.

AY does not dispute that there are now four different tests that the courts of appeals use to determine whether a note is a "security." AY argues, however, that all of these tests produce identical results, and that there is no real conflict among the circuits. (See AY Brief at 9-12.) AY is wrong. This case is the clearest evidence that the various tests, applied to the same set of facts, will produce directly contrary results. As the SEC stated on rehearing, "Notes that are part of a large offering to the public or to unsophisticated investors are almost invariably securities." (A-6.) The Eighth Circuit's decision to the contrary therefore conflicts with the decisions of

other circuits that have considered note offerings similar to the Co-Op's and held the notes to be securities.[2]

Furthermore, the Eighth Circuit's application of the Howey test to notes, while erroneous, is not an aberration. The D.C. Circuit also has applied Howey to notes,[3] and Professor Louis Loss has described the Sixth and Ninth Circuits' "risk capital" test as "merely an

---

[2] See, e.g., Underhill v. Royal, 769 F.2d 1426, 1431 (9th Cir. 1985); Hunssinger v. Rockford Business Credits, Inc., 745 F.2d 484, 492 (7th Cir. 1984); United States v. Farris, 614 F.2d 634, 641 (9th Cir. 1979), cert. denied, 447 U.S. 926 (1980); McClure v. First Nat'l Bank, 497 F.2d 490, 493 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975).

[3] See Baurer v. Planning Group, Inc., 669 F.2d 770, 777-79 (D.C. Cir. 1981); Johnson v. Computer Technology Services, 670 F. Supp. 1036, 1038 (D.D.C. 1987).

elaboration of Howey."[4] Other courts of appeals have flatly rejected the application of the Howey investment contract test to notes. (Petition at 5 & n.7.)

Nor is the Eighth Circuit's test the only source of conflict. The "risk capital" test and the "investment vs. commercial" test take different approaches to demand and short-term notes. While the Ninth Circuit has stated that "a demand or short-term note is almost ipso facto not a security . . . ,"[5] the Fifth Circuit has held that "the Act covers all investment notes, no matter how short their maturity

---

[4] L. Loss, Fundamentals of Securities Regulation 168 n.7 (1988).

[5] Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1257 (9th Cir. 1976).

. . . ."[6] Although they are contradictory, these approaches at least agree that there is no basis for AY's effort to distinguish demand notes from short-term notes.'

There are other real conflicts among the courts applying the various tests. For example, the First Circuit, which has adopted the "commercial vs.

---

[6] McClure v. First Nat'l Bank, 497 F.2d 490, 493-94 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975) (emphasis in original). Remarkably, AY argues that under the leading "commercial vs. investment" test, the Co-Op's demand notes are not securities. (AY Brief at 11.) The SEC and the Class, however, believe that any court applying this leading test would hold that these demand notes are securities. (SEC Brief on Rehearing at A-8; Petition at 3.)

[7] The fact that the Co-Op's promissory notes were payable on demand was merely an enticement to encourage investment. (See A-18.) Once the Co-Op filed for bankruptcy and the fraud became public knowledge, the demand feature of the notes was of no use to the over 1600 defrauded investors.

investment" test, has criticized the "risk capital" test for excluding investments such as "markets in commercial paper, [which] are specifically designed to be low risk, yet such transactions were clearly intended by Congress to fall within the Acts." Futura Dev. Corp. v. Centex Corp., 761 F.2d 33, 41 (1st Cir.), cert. denied, 474 U.S. 850 (1985).[8]

---

[8] Numerous commentators have studied the differences between these tests and urged the uniform application of a single test. See, e.g., Lizzul, The Evolution of Bank Term Lending and the Status of Term Notes Under the Federal Securities Laws, 31 Syracuse L. Rev. 959, 995-1002 (1980) ("[B]y applying the commercial/investment test, a court is more likely to reach a resolution suggested by an examination of the legislative history of the securities acts.").

CONCLUSION

According to the SEC and state regulators, the Eighth Circuit's decision, if left unreviewed, will cause serious enforcement problems in all of the states. If AY is right, federal and state securities agencies are powerless to regulate the offering or sale of demand notes in any state, even if the notes are sold to the general public as investments. This case presents an opportunity for this Court to resolve a long-standing division among the courts of appeals by adopting a uniform test for notes.

Respectfully submitted,

Gary M. Elden
(Counsel of Record)
John R. McCambridge
Jay R. Hoffman

Attorneys for Petitioners

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

Nos. 87-1726, 87-1727, 87-1803
87-2533, 88-1014

CONSOLIDATED

ARTHUR YOUNG & CO.,

Appellant,

v.

BOB REVES; ROBERT H. GIBBS; & FRANCES GRAHAM,

Appellees.

On Appeal from the United States
District Court for the
Western District of Arkansas

**MEMORANDUM OF
THE SECURITIES AND EXCHANGE COMMISSION,
AMICUS CURIAE, IN SUPPORT OF APPELLEES'
PETITION FOR REHEARING WITH THEIR
SUGGESTION FOR REHEARING EN BANC**

FILED SEPTEMBER 27, 1988

The Securities and Exchange Commission, the agency primarily

responsible for the administration and enforcement of the federal securities laws, submits this memorandum, amicus curiae, in support of the appellees' petition for rehearing with their suggestion for rehearing en banc. The Commission believes that the notes at issue in this case -- widely sold by a farmers co-op to unsophisticated individuals as investments -- are securities under the federal securities laws. The sale of these same instruments constituted the basis, three years ago, of a Commission enforcement action for violations of the registration and antifraud provisions of the federal securities laws.[1] In the Commission's

---

[1] See SEC v. White, No. CA 86-2015 (W.D. Ark. 1986), Lit. Release No. 11,066 (April 17, 1986), 35 SEC Docket 874; Lit. Release No. 11,087 (May 1, 1986), 35 SEC Docket 1076. The Commission's case was concluded with the entry of consent injunctions.

view, the decision in this case -- that these instruments are not securities -- is incorrect and will erode securities law protection in this Circuit for purchasers of notes. The Court's analysis and result stand alone, contrary to the numerous decisions of other courts of appeals in both Commission and private actions.[2]

The instruments in this case are interest-bearing demand notes. Neither the demand feature of the notes nor the fact that they bore interest -- the factors relied on by this Court in holding that the notes are not securities -- justifies the Court's decision.

1. The demand feature of these notes should not affect the determination

---

[2] Private actions under the federal securities laws serve as a "necessary supplement" to the Commission's enforcement actions. See, e.g., Basic, Inc. v. Levinson, 108 S. Ct. 978, 983 (1988).

whether they are securities. "'[I]t is the character of the note, not its maturity date, which determines coverage under both the registration provisions of the Securities Act of 1933, and the Securities Exchange Act of 1934. * * * The paramount concern * * * is the nature of the transaction in which the note is issued.'" C.N.S. Enterprises v. G. & G. Enterprises, 508 F.2d 1354, 1361 (7th Cir.), cert. denied, 423 U.S. 825 (1975) (quoting SEC v. Continental Commodities Corp., 497 F.2d 516, 525 (5th Cir. 1974)).

In determining whether a note is a security, the courts of appeals have considered whether the transaction is investment (indicating a security) or commercial.[3] The ultimate question "is

---

[3] The tests developed by the courts of appeals are set forth in the briefs submitted to the Court by the petitioners and the Arkansas Securities Department. See generally, e.g., C.N.S. Enterprises,

whether the plaintiffs are simply borrowers [or lenders] in a commercial transaction who are not protected by the [securities laws] or investors in a securities transaction who are protected." C.N.S. Enterprises, 508 F.2d at 1359. Resolution of this question in a particular context involves consideration of a number of factors, only one of which is whether the notes are payable on demand. Other factors include: (i) whether the obligations are issued to a single party or to a large class of investors; (ii) how the instrument

---

508 F.2d at 1354. See also Exchange National Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1137-38 (2d Cir. 1976) (The analysis starts with a strong presumption that a note is a security unless it "bear[s] a strong family resemblance" to those issued in connection with consumer transactions or brokerage customer loans, and those evidencing certain bank loans and commercial business loans -- where the context does not require protection of the securities laws), and SEC v. American Board of Trade, 751 F.2d 529, 538-40 (2d Cir. 1984).

is characterized in the business community, in relevant financial statements, or by the parties themselves; (iii) whether the proceeds are to be used to purchase specific assets or services (commercial) or for general financing purposes (investment); (iv) whether the noteholders are protected by collateral; (v) the extent of reliance on efforts of others; and (vi) the number of notes issued, the number of payees, and the dollar amount of the transaction. Id. at 1361. See also Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1257-58 (9th Cir. 1976). Particularly significant to this analysis is the public offering aspect. Notes that are part of a large offering to the public or to unsophisticated investors are almost invariably securities. See, e.g., United States v. Farris, 614 F.2d 634, 641 (9th Cir. 1979), cert. denied, 447 U.S. 926

(1980); McClure v. First National Bank of Lubbock, Tex., 497 F.2d 490, 493 (5th Cir. 1974).[4] Where courts have determined that notes are commercial in nature, rather than investment, the cases consistently involve individually-negotiated transactions and not large-scale offerings to the public.[5]

---

[4] Instruments offered or sold to the public on the representation that they are an attractive investment are generally deemed to be securities. As the Supreme Court has emphasized, courts should consider "'the plan of distribution * * * and the economic inducement held out to the prospect. In the enforcement of an act such as [the Securities Act] it is not inappropriate that promoters' offerings be judged as being what they were represented to be.'" SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 211 (1967) (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 352-53 (1943)).

[5] The Securities Act and the Securities Exchange Act contain certain exceptions for short-term notes. See Section 3(a)(3) of the Securities Act, 15 U.S.C. 77c(a)(3) (exemption from registration); Section 3(a)(10) of the Securities Exchange Act, 15 U.S.C. 78c(a)(10) (exclusion from definition of "security"). These exceptions for short-term paper are limited to "prime quality negotiable [commercial] paper of a type

When these factors are applied to this case, the Farmers Co-op notes fall on the investment side of this dichotomy and are clearly securities. The notes, which were neither collateralized (J.A. 1979) nor insured, were sold to a large class of investors who resided in at least two states, and included not only the Co-op's members but also any other person doing business with the Co-op. J.A. 1815. The Co-op itself expressly considered the sale of the notes an "INVESTMENT PROGRAM." It

---

not ordinarily purchased by the general public, that is, paper used to facilitate well-recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks." Zabriskie v. Lewis, 507 F.2d 546, 550 (10th Cir. 1974) (quoting Securities Act Release No. 4412, 26 Fed. Reg. 9158 (1961)). See also Zeller v. Bogue Electric Mfg. Corp., 476 F.2d 795, 800 (2d Cir.), cert. denied, 414 U.S. 908 (1973); Sanders v. John Nuveen & Co. 463 F.2d 1075, 1078-80 (7th Cir.), cert. denied, 409 U.S. 1009 (1972); Anderson v. Frances I. du Pont & Co., 291 F. Supp. 705, 708-09 (D. Minn. 1968).

advertised the program as such in a widely-distributed monthly newsletter, stating:

> YOUR CO-OP has more than $11,000,000 in assets to stand behind your investments. The investment is not Federal (sic) insured but it is . . . Safe . . . Secure . . . and Available when you need it.

J.A. 1819-1904 (emphasis supplied). In addition, no financial information was ever disclosed to investors at the time of sale. J.A. 1816. The proceeds were used to finance the Co-op's ventures and day-to-day business. Finally, a large number of notes were issued to numerous payees, with some 1,600 investors still holding notes at the time the Co-op filed for bankruptcy in 1984.

In concluding in this case that the demand nature of the notes is alone sufficient to preclude them from being securities, this Court relied, in part, on a statement by the Ninth Circuit in Great

Western, 532 F.2d at 1257-58, that a demand feature is uncharacteristic of a security. That statement, however, must be read together with the other factors relied on by the Great Western court in determining whether the note in that case was a security. The Ninth Circuit examined a number of factors: (1) time, (2) collateralization, (3) form of the obligation, (4) circumstances of issue, (5) relationship between the amount borrowed and the size of the borrower's business, and (6) the contemplated use of the funds. On balance, based on the specific facts of that case, the court determined that the transaction -- an individually-negotiated bank loan, partially secured by collateral in the form of a bank account with a mandatory minimum balance of $300,000 (id. at 1258) -- was commercial in nature. We believe that the Great Western court, based

on the rationale detailed in the case, would have found the demand notes issued in this case to be securities.

2. With respect to the interest-bearing feature of the notes, this Court in the present case applied the definition of "investment contract" enunciated by the Supreme Court in SEC v. J.W. Howey Co., 328 U.S. 293 (1946), and concluded that "profit" under that analysis does not include the interest to be received by the noteholders. Once it has been determined that a note is investment in nature and therefore within the statutory term "note," however, it is unnecessary to consider whether it is also a security in the form of an "investment contract" under Howey. As recently explained by the Supreme Court, in a case involving common stock, the Howey test for an investment contract

> was designed to determine whether a particular instrument is an

> "investment contract," not whether it fits within any of the examples listed in the statutory definition of "security." * * * Moreover, applying the Howey test to traditional stock and all other types of instruments listed in the statutory definition would make the Acts' enumeration of many types of instruments superfluous.

Landreth Timber Co. v. Landreth, 471 U.S. 681, 691-92 (1985) (emphasis in original; citations omitted.).[6]

Nevertheless, even under the Howey test, the fact that the notes bear interest does not prevent them from satisfying that

---

[6] In applying the Howey test here, this Court cited Union Nat'l Bank of Little Rock v. Farmers Bank, 786 F.2d 881 (8th Cir. 1986) and Kansas State Bank v. Citizens Bank, 737 F.2d 1490 (8th Cir. 1984). Those cases involved the question whether certain loan participations were securities. The Court concluded in those cases, after determining that loan participations do not fit within the list of securities enumerated in the statute, that the transactions fell within the catchall of "investment contracts," and applied the Howey test. In contrast, in this case the Court has before it a "note," which Congress has determined by statute to be a security.

test. See e.g., Gary Plastic Pkg. Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230 (2d Cir. 1985), where the court found that an interest-bearing investment program (involving certificates of deposit) was a security under Howey. "Profit" under Howey covers any type of return on an investment, including interest. The fact that a return is in the form of interest is irrelevant under both the Howey test and any note analysis. "[A] fixed rate of interest is simply a characteristic of the general category 'notes.' A note that bears a fixed rate of interest is just as likely to be an investment as it is likely to be evidence of a commercial loan." Hunssinger v. Rockford Business Credit, 745 F.2d 484, 489 (7th Cir. 1984).[7] Thus, whether this Court

---

[7] The Hunssinger court concluded: "the district court erred when it relied upon a fixed rate of interest to exclude

assesses the Co-op notes under the commercial-investment analysis inapplicable to notes or under the Howey test, the fact that there may have been fixed or variable rates of interest sheds no light on the question whether they are securities.

Accordingly, the Securities and Exchange Commission urges this Court to grant the appellees' petition for rehearing with their suggestion for rehearing en banc in order to reconsider whether the notes issued by the Farmers Co-op are securities subject to the protections of the federal securities laws.

---

the note in this case from the coverage of the securities laws." Id.

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

[illegible]

NASAA

VIA TELECOPIER

March 23, 1989

Mr. Thomas W. Merrill
Deputy Solicitor General
Department of Justice
Room 5137
Tenth and Constitution Avenue, N.W.
Washington, D.C. 20530

Dear Mr. Merrill:

This letter is written on behalf of the North American Securities Administrators Association, Inc. ("NASAA"), to urge the Office of the Solicitor General to recommend that the United States Supreme Court grant certiorari in Reves v. Arthur Young & Co., Docket No. 88-1480. We understand that the U.S. Securities and Exchange Commission is also asking your office to recommend Supreme Court review of this important, and erroneous, decision of the Eighth Circuit.[1]

NASAA is the association of the securities administrators that supervise the securities industry, regulate the capital markets, and enforce investor protection statutes in the fifty states, District of Columbia and Puerto Rico. State securities regulation is coextensive with the federal securities regulatory system.[2]

State securities administrators devote a large part of their resources to investigation and prosecution of fraudulent securities schemes. Unfortunately, in recent years a number of fraudulent schemes prosecuted by states have involved sales of investment notes virtually identical to the notes involved in Reves. Because the definition of "securities" contained in state statutes is substantially the same as that in the federal law, and because state courts often follow federal precedent in construing the definition of securities, Reves, if allowed to stand, may cause mischief to state law enforcement programs designed to protect citizens from investments similar to those involved in Reves.

---

[1] 856 F.2d 52 (1988).

[2] Securities Act of 1933 § 18, 15 U.S.C. § 77r.

[illegible]

The Court in Reves also incorrectly held that the notes did not constitute securities under the Arkansas Securities Act.[3] In fact, the Arkansas courts have interpreted the Arkansas statute more expansively than did the Court in Reves, having adopted the "risk capital" test for securities in that jurisdiction.[4]

It should also be noted that a split exists in the circuits regarding whether promissory notes such as the Reves notes are securities.[5]

The importance of this case to state law enforcement officials is simply that the instrument involved in the court's interpretation has become the subject of fraud and abuse in the investment community, and it is exactly the type of abuse that securities laws are designed to prevent. The Reves Court noted that investors in the notes were promised higher interest rates than could be obtained from area banks or savings and loans. Promoters using the same scheme as the sellers in Reves often promise better returns on investments than can be had at local financial institutions. The reason rates were higher was because risk was higher. Risk is a primary determinate in interest rate differentials. Investors risked their money to obtain a profit greater than that available from federally insured deposits.

Promoters of Reves - type schemes fail to disclose the risk involved in buying uninsured investments or the risk of failure of their businesses. They market their notes to the unsophisticated and unsuspecting, to those whom securities law disclosures are designed to protect. The Reves decision does not involve financing arrangements among commercial lenders but instead involves retail sales to small investors of standardized evidences of indebtedness.

Fraudulent retail sales of demand notes and other debt instruments became popular scams during the mid 1980's when interest rates paid to individuals by savings institutions began to drop as inflation rates decreased. They remain common still. In December 1988, for example, the California Department of Corporations brought an

---

[3] Reves, supra, at 55.

[4] Smith v. State, 266 Ark. 556, 587 S.W. 2d 50 (Ark. App. 1979), Cert. denied 445 U.S. 905 (1980); Schultz v. Rector-Phillips Morse, Inc., 261 Ark. 769, 552 S.W.2d 4 (Ark. Sup. 1977).

[5] Hunssinger v. Rockford Business Credit, Inc., 754 F.2d 484 (7th Cir. 1984), holding that a promissory note is a security; similar, Sanderson v. Rosthansand, 682 F. Supp. 205 (S.D.N.Y. 1988); Bachsair v. Bank of Ravenswood, 663 F.Supp. 1207 (N.D. Ill. 1987).

enforcement action against a company that advertised its notes on Spanish language television stations and attracted over 900 investors before the Department obtained an injunction and receivership based on securities law violations.[6] The Department is now working with the receiver to retrieve assets, some of which may have been moved out of the country.

The importance of Supreme Court review of Reves is underscored by the experience of state and federal law enforcement officials after the Ninth Circuit's decision in SEC v. Belmont Reid & Co., Inc.[7] In that case, the Court interpreted the federal securities definition to exclude an investment scheme involving sale to small investors of interests in supposedly unmined precious metals, still "in the ground." (These deals are now commonly called "dirt pile schemes" in the law enforcement community.) That decision has effectively foreclosed state as well as federal securities officials in the states of the Ninth Circuit from prosecuting dirt pile schemes. State officials estimate that thirty to forty fraudulent boiler rooms were spawned on the West Coast as a direct result of Belmont Reid, causing millions of dollars of losses.

We again urge you to recommend that the Supreme Court review Reves v. Arthur Young & Co. State securities officials are vitally interested in the outcome of this case, and they fear the damage that may be done to law enforcement programs and to their citizens if the Eighth Circuit decision is allowed to stand. Thank you for your consideration of this issue. If we may supply background material for the information in this letter or be of further assistance in any other way, please contact us.

Very truly yours,

Lee Polson
Executive Director and
General Counsel

---

[6] In preparing this letter, NASAA has asked its members to supply additional examples of fraudulent promissory note schemes, and we will provide them to you at your request.

[7] 794 F.2d 1388 (1986).

COOP

INVESTMENT PROGRAM

PAYING
14% INTEREST

The CO-OP will continue to review the money market for future adjustment.

For Complete Details
Ask These Members of Your CO-OP Team

VAN BUREN ..... Jack White
Kent Gordon — Eddie Joe Smith

CAULKSVILLE ..... Jack Sailor

SALLISAW ..... Harold Wallace - Donna McClure

MUSKOGEE ..... Jerry Finley, Robert Tracy

STIGLER ..... Sam Pendergrass

YOUR CO-OP has more than [illegible] assets to stand behind your investments. The investment is not Federally insured but it is Safe, Secure, and is safe when you need it. Interest is computed to the day of withdrawal.

EXAMPLES ON 14% INTEREST
ON DEMAND NOTES

note	net monthly*	net annually*
$ 2 000 00	$ 33 33	$ 280 00
3 000 00	35 00	420 00
4 000 00	46 67	560 00
5 000 00	58 33	700 00
6 000 00	70 00	840 00
7 000 00	81 67	980 00
8 000 00	93 33	1 120 00
9 000 00	105 00	1 260 00
10 000 00	116 67	1 400 00

NOTES ARE PAYABLE ON DEMAND, so any time you need your money we will write you a check. There is no waiting period.

Farmers Co-op of AR-OK

Drawer U, Industrial Pk., VAN BUREN, ARKANSAS
CAULKSVILLE, ARKANSAS
303 West Cherokee, SALLISAW, OKLAHOMA
724 Mall Street, MUSKOGEE, OKLAHOMA
STIGLER, OKLAHOMA

1873

AMICUS CURIAE

BRIEF

No. 88-1480

Supreme Court, U.S.
FILED
MAY 20 1989
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1988

BOB REVES, ET AL., PETITIONERS

v.

ARTHUR YOUNG & CO.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION AS AMICI CURIAE

WILLIAM C. BRYSON
Acting Solicitor General

THOMAS W. MERRILL
Deputy Solicitor General

MICHAEL R. LAZERWITZ
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

MARTHA H. MCNEELY
Special Counsel

EVA MARIE CARNEY
Attorney
Securities and Exchange Commission
Washington, D.C. 20549

24 pp

QUESTION PRESENTED

Whether interest-bearing promissory notes, payable on demand, that are widely sold by a farmers cooperative association to its members and others as investments, are securities under the federal securities laws.

TABLE OF CONTENTS

	Page
Statement	1
Discussion	6
Conclusion	19

TABLE OF AUTHORITIES

Cases:

American Bank & Trust v. *Wallace*, 702 F.2d 93 (6th Cir. 1983) 15
Basic, Inc. v. *Levinson*, 108 S. Ct. 978 (1988) 14
Baurer v. *Planning Group, Inc.*, 669 F.2d 770 (D.C. Cir. 1981) 10
Bellah v. *First Nat'l Bank*, 495 F.2d 1109 (5th Cir. 1974) .. 15
Blonder-Tongue Laboratories, Inc. v. *University of Illinois Found.*, 402 U.S. 313 (1971) 17
Briggs v. *Sterner*, 529 F. Supp. 1155 (S.D. Iowa 1981) ... 12
C.N.S. Enterprises, Inc. v. *G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), cert. denied, 423 U.S. 825 (1975) 9, 15
Carlson v. *Green*, 446 U.S. 14 (1980) 17
Chemical Bank v. *Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), cert. denied, 469 U.S. 884 (1984) 16
El Khadem v. *Equity Securities Corp.*, 494 F.2d 1224 (9th Cir.), cert. denied, 419 U.S. 900 (1974) 18
Exchange Nat'l Bank v. *Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976) 15, 16, 18
Futura Development Corp. v. *Centex Corp.*, 761 F.2d 33 (1st Cir.), cert. denied, 474 U.S. 850 (1985) 15
Gary Plastic Packaging Corp. v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985) 18
Great Western Bank & Trust v. *Kotz*, 532 F.2d 1252 (9th Cir. 1976) 4, 6, 12, 15-16
Hunssinger v. *Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984) 13, 14
Landreth Timber Co. v. *Landreth*, 471 U.S. 681 (1985) .. 5-6, 7, 9, 14, 18
Lawler v. *Gilliam*, 569 F.2d 1283 (4th Cir. 1978) 13
Lino v. *City Investing Co.*, 487 F.2d 689 (3d Cir. 1973) ... 14, 15

Cases – Continued:

	Page
Marine Bank v. *Weaver*, 455 U.S. 551 (1982)	11
McClure v. *First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975)	10, 11, 14
Sanders v. *John Nuveen & Co.*, 463 F.2d 1075 (7th Cir.), cert. denied, 409 U.S. 1009 (1972)	10
SEC v. *American Board of Trade, Inc.*, 751 F.2d 529 (2d Cir. 1984)	8, 10, 11, 13, 16
SEC v. *Bartlett*, 422 F.2d 475 (8th Cir. 1970)	8
SEC v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943)	7
SEC v. *Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974)	9, 11
SEC v. *W.J. Howey Co.*, 328 U.S. 293 (1946)	5, 18
SEC v. *Kuhen*, No. CA 3-85-1090-G (N.D. Tex. June 17, 1985)	8
SEC v. *Predator Automotive Concepts, Inc.*, No. 88-255 EDP (E.D. Cal. Feb. 8th and 13, 1989)	8
SEC v. *White*, No. CA 86-2015 (W.D. Ark. May 1, 1986)	8
SEC v. *World Radio Mission*, 544 F.2d 535 (1st Cir. 1976)	13-14
Tcherepnin v. *Knight*, 389 U.S. 332 (1967)	11
The Fund of Funds, Ltd. v. *Vesco*, [1976-1977] Fed. Sec. L. Rep. (CCH) ¶ 95,644 (S.D.N.Y. July 21, 1976)	12
Union Planters Nat'l Bank v. *Commercial Credit Business Loans*, 651 F.2d 1174 (6th Cir.), cert. denied, 454 U.S. 1124 (1981)	18
United Housing Found., Inc. v. *Forman*, 421 U.S. 837 (1975)	5, 9
United States v. *Bloomquist*, No. CA 88-NCR-0056G (D. Utah Mar. 8, 1989)	14
United States v. *Farris*, 614 F.2d 634 (9th Cir. 1979), cert. denied, 447 U.S. 926 (1980)	13
Zabriskie v. *Lewis*, 507 F.2d 546 (10th Cir. 1974)	10, 15
Zeller v. *Bogue Electric Mfg. Corp.*, 476 F.2d 795 (2d Cir.), cert. denied, 414 U.S. 908 (1973)	10, 11, 12

Statutes, regulation, and rule:

	Page
Bankruptcy Code, 11 U.S.C. 1101 *et seq.* (Ch. 11)	2
Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. 1961 *et seq.* (1982 & Supp. V 1987)	3

Statutes, regulation, and rule – Continued:

	Page
Securities Act of 1933, 15 U.S.C. 77a *et seq.*:	
§ 2, 15 U.S.C. 77b	10
§ 2(1), 15 U.S.C. 77b(1)	9
§ 3(a)(3), 15 U.S.C. 77c(a)(3)	10
Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*:	
§ 3(a), 15 U.S.C. 78c(a)	10
§ 3(a)(10), 15 U.S.C. 78c(a)(10)	5, 9, 10
§ 10(b), 15 U.S.C. 78j(b)	3
Arkansas Securities Act, Ark. Stat. Ann. § 67-1256 (1980)	3, 6
U.C.C. § 3-104 (1977)	9
17 C.F.R. 240.10b-5	3
Sup. Ct. R. 21.1(a)	17

Miscellaneous:

	Page
11 Am. Jur. 2d *Bills and Notes* (1963)	9
H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933)	9, 10
Jacobs, *The Meaning of "Security" Under Rule 10b-5*, 29 N.Y.L. Sch. L. Rev. 211 (1984)	15, 16-17, 18
L. Loss, *Fundamentals of Securities Regulation* (2d ed. 1988)	10
2 L. Loss & J. Seligman, *Securities Regulation* (3d ed. 1989)	15
Securities Act Release No. 4412 (Sept. 20, 1961), 1 Fed. Sec. L. Rep. (CCH) ¶ 2045 (Apr. 24, 1987)	10

In the Supreme Court of the United States

OCTOBER TERM, 1988

No. 88-1480

BOB REVES, ET AL., PETITIONERS

v.

ARTHUR YOUNG & CO.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION AS AMICI CURIAE

This submission responds to the Court's invitation to the Solicitor General to file a brief expressing the views of the United States.

STATEMENT

1. The Farmers Co-Op of Arkansas and Oklahoma, Inc. (Co-Op) was an agricultural cooperative that provided a market and supply source for its 23,000 members located throughout northwest Arkansas and northeast Oklahoma. The Co-Op charged only a nominal membership fee. In addition to borrowing money from banks and other financial institutions, the Co-Op obtained funds for its day-to-day operations and business ventures from the sale of interest-bearing promissory notes, payable on demand, to its members and others with whom it conducted business, as part of a self-styled "investment program" (Pet. C.A. App. 1908). Pet. App. A13-A14, A72, A76; Pet. C.A. App. 1905-1908.

Notes sold through the Co-Op's investment program were available in the minimum denomination of $100, and carried

fluctuating interest rates generally higher than those available from local financial institutions. The Co-Op determined the rate of interest each month based on current market rates; the notes were not collateralized. Pet. App. A14, A70, A72; Pet. C.A. App. 1773-1782, 1905-1920. In its widely circulated monthly newsletters, the Co-Op advertised that it had substantial assets backing the participants' "investments" in the program. Those advertisements also acknowledged that the investments were not "Federal [*sic*] Insured," but stated that each investment was "safe . . . secure . . . and available when you need it" (*e.g.*, Pet. C.A. App. 1820, 1822, 1824, 1826, 1828, 1830); Pet. App. 70. The Co-Op disclosed no financial information to investors at the time of sale other than a statement of the Co-Op's total assets. It did, however, distribute condensed versions of audited financial statements to those persons who attended the Co-Op's annual meetings. Pet. App. A14-A15.

In the early 1980s, the Co-Op hired respondent, the accounting firm of Arthur Young & Company, to audit and report on its 1981 and 1982 financial statements. Respondent's representatives gave brief presentations at the Co-Op's 1982 and 1983 annual meetings explaining the Co-Op's general financial condition; some 350 of the Co-Op's members attended those meetings. Respondent's representatives also told the members that complete audited financial statements, together with respondent's report on them, were available at the Co-Op's headquarters. Pet. App. A15.

2. Early in 1984, the Co-Op filed for reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. 1101 *et seq.* At that time, some 1600 individual investors held Co-Op notes having a total face value of over $10,000,000. Pet. App. A45, A73. After the Co-Op's financial collapse, petitioners, representing a class of purchasers of the Co-Op's notes, together with the Co-Op's trustee in bankruptcy, filed actions in the United States District Court for Western District of Arkansas against the Co-Op, its principal officers and directors, respondent, and others.[1]

[1] The district court later consolidated the complaints of the trustee and petitioners. In September 1985, the district court certified petitioners' class action. See *Robertson* v. *White*, 633 F. Supp. 954, 960 (W.D. Ark. 1986).

Petitioners alleged, among other claims,[2] that respondent and the other defendants had committed fraud in connection with the sale of securities—the Co-Op's notes—in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), Rule 10b-5, 17 C.F.R. 240.10b-5, and Section 67-1256 of the Arkansas Securities Act, Ark. Stat. Ann. § 67-1256 (1980). Pet. App. A11-A12.[3]

During extensive pretrial litigation, certain defendants, joined by respondent,[4] argued that the Co-Op's notes were not securities under either federal or state law, and thus sought dismissal of petitioners' securities law claims. After examining state law and precedent, together with analogous federal case law, the district court held that the Co-Op's notes were securities under the Arkansas Securities Act. Pet. App. A32-A81.[5] In sum, the court found that "salient features of the notes offered by the [Co-Op] direct a conclusion that a broad scale offering of unsecured debt instruments to a passive public constitutes an investment transaction, rather than a commercial loan" (*id.* at

[2] Petitioners had also charged respondent with violations of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. 1961 *et seq.* (1982 & Supp. V 1987). The district court granted respondent's motion for summary judgment on those claims and the court of appeals upheld that ruling. Pet. App. A26-A27. In addition, the trustee in bankruptcy had alleged a separate breach of contract claim against respondent. The district court, on respondent's motion, dismissed that claim and the court of appeals affirmed. Pet. App. A27. Neither of these claims is at issue before this Court.

[3] With respect to respondent, petitioners essentially claimed that the accounting firm had fraudulently induced them to purchase the Co-Op's notes. Petitioners contended, among other things, that respondent deliberately failed to follow generally accepted accounting principles in conducting its audits and thus overvalued one of the Co-Op's major assets. Petitioners also asserted that, had respondent used proper accounting techniques, "the Co-op's insolvency would have been readily apparent," and that respondent "avoided the correct accounting treatment and lied about its reasons for so doing, in order to inflate the assets and net worth of the Co-op" (Pet. App. A16).

[4] See Resp. Amicus Mem. With Respect To Whether The Co-Op Demand Notes Are Securities, *Robertson* v. *White*, Nos. 85-2044, 85-2096, 85-2155, and 85-2250 (W.D. Ark.).

[5] The court, although reviewing and discussing federal cases, reserved ruling on the federal securities issue pending further argument. Pet. App. A35-A36.

A39-A40).[6] In a separate ruling several months later denying defendants' motion for summary judgment, the district court, apparently based on its earlier review of federal law, held that the Co-Op's notes were securities under the federal securities laws. Pet. App. A30; see also *Robertson* v. *White*, 633 F. Supp. 954, 976 (W.D. Ark. 1986).

Petitioners' federal and state securities claims against respondent were tried to a jury. After a five-week trial, the jury found respondent liable for violating both federal and state securities laws and awarded petitioners over $6.1 million. Given petitioners' substantial settlements with the other defendants, the district court ordered that the jury's award be subject to a $5.7 million credit, conditioned on approval of those settlements. Pet. App. A11, A17; Resp. C.A. App. 3.[7] Thereafter, the district court denied respondent's motion for judgment notwithstanding the

[6] The court rejected respondent's argument, based on *Great Western Bank & Trust* v. *Kotz*, 532 F.2d 1252, 1257 (9th Cir. 1976) (per curiam), that the demand feature of the Co-Op's notes took the notes outside the purview of the securities laws. The court first observed that *Great Western* itself had suggested that demand notes could be considered securities if " 'payment is dependent on the success of a risky enterprise' " (Pet. App. A74 (quoting *Great Western*, 532 F.2d at 1257)). The court then criticized respondent's argument as elevating "form over substance" and permitting

> the issuer, in this case the Co-Op, to choose a form—*i.e.*, demand notes—which evades regulation, while allowing it to substantially practice the very evil which blue sky laws were designed to deter: the broadscale, public solicitation of large amounts of unsecured capital for deployment in a speculative venture.

Pet. App. A74-A75. The court observed that the Co-Op's notes "contain no restriction as to the use to which the funds may be put" and that this fact "further puts the 'investor' at risk" (*id.* at A75). Given these circumstances, the court concluded that the Co-Op's notes were securities, "notwithstanding the contention that under other circumstances such an instrument might not be considered an investment" (*id.* at A76).

[7] Before trial, petitioners had reached settlements with most of the other defendants, who agreed to pay the class members a total of $5,744,780. See Resp. C.A. App. 3.

The bankruptcy trustee's separate common law claims against respondent were also tried to the jury. The jury returned verdicts in respondent's favor on those claims. Pet. App. A17.

verdict and its alternative motion for rehearing with respect to the damages issue. Resp. C.A. App. 11-12, 16-82.

Respondent appealed from the district court's denial of its post-trial motions. Respondent raised a number of claims, including renewing its contention that the Co-Op's demand notes are not securities under either federal or state securities laws. See Resp. C.A. Br. 33-37.[8]

3. The court of appeals reversed the district court's denial of respondent's motion for judgment notwithstanding the verdict, holding that the Co-Op's "demand notes * * * are not 'securities' for purposes of either [the] federal or Arkansas securities acts" (Pet. App. A13).[9]

The court of appeals observed that the Securities Exchange Act's definition of a security as including "any note" (15 U.S.C. 78c(a)(10)) does not resolve the issue because " 'Congress intended the application of [the federal securities acts] to turn on the economic realities underlying a transaction and not on the name appended thereto.' " Pet. App. A17-A18 (quoting *United Housing Found., Inc.* v. *Forman*, 421 U.S. 837, 849 (1975) (brackets in original)). The court thus stated that the Co-Op's notes could not be securities unless they met the test set forth in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946), for identifying "investment contracts," another term included in the statutory definition. Pet. App. A19-A20.[10]

Before applying the *Howey* test, however, the court of appeals, in light of this Court's recent decision in *Landreth Timber*

[8] Respondent also contended that the district court erred in submitting petitioners' federal securities claim to the jury, arguing that respondent had no duty to make any disclosures to the class members, the record contained no evidence that respondent caused any class member to purchase the Co-Op's notes, and petitioners presented no evidence showing that any class member relied on respondent's auditing statements or reports. Resp. C.A. Br. 9-19. Respondent also challenged the evidentiary support for and measure of the damages award (*id.* at 29-33), and claimed that the district court erred in certifying the class (*id.* at 37-39).

[9] In light of this disposition, the court of appeals did not reach the additional issues raised by respondent. See note 8, *supra*.

[10] Under the *Howey* test, the instrument must represent "an investment of money in a common enterprise with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301; see Pet. App. A21.

Co. v. *Landreth*, 471 U.S. 681 (1985), considered whether the Co-Op's demand notes bear both a name included within the statutory definition of a security and "the usual characteristics of a security" (Pet. App. A20). Although the notes obviously bear the name of a security, the court concluded that "[t]he demand nature of the notes is very uncharacteristic of a security" (*id.* at A20, A21 (citing *Great Western Bank & Trust* v. *Kotz*, 532 F.2d 1252, 1257-1258 (9th Cir. 1976) (per curiam)). Accordingly, the court proceeded to apply the *Howey* test.

The court of appeals concluded that the notes failed to satisfy two elements of the *Howey* test. First, after observing that the Co-Op's members " 'deposited' their money with the Co-Op in order to earn a higher return than could be obtained from a bank," the court found that "this transaction was much more akin to a commercial lending arrangement than an investment transaction" (Pet. App. A22). Second, the court concluded that the noteholders' expected return, an interest rate fixed by an established market rate, did not qualify as the requisite "reasonable expectation of profit" under *Howey*. *Id.* at A22-A23.

In sum, having determined that the Co-Op's demand notes "were uncharacteristic of securities, and also failed the *Howey* test," the court of appeals held that those notes are not securities under the federal securities laws and therefore reversed the district court's denial of respondent's post-trial motion (Pet. App. A23).[11]

4. The court of appeals, with four judges dissenting, thereafter denied a petition for rehearing and suggestion for rehearing en banc.[12]

DISCUSSION

As this Court has acknowledged, "[i]t is fair to say that our cases have not been entirely clear on the proper method of

[11] The court of appeals also determined that the definitions of a security under the federal securities laws and the Arkansas Securities Act "are essentially the same" (Pet. App. A25 n.3). Accordingly, it concluded that the Co-Op's notes are not securities under state law. *Id.* at A23-A25.

[12] The Securities and Exchange Commission and the Arkansas Securities Department filed briefs as amici curiae supporting petitioners' request for rehearing and suggestion for rehearing en banc.

analysis for determining when an instrument is a 'security.' " *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 688 (1985). In *Landreth*, the Court sought to clarify the law, particularly with respect to instruments denominated "stock." The Court concluded that "the plain meaning of the statutory definition [of security in Section 2(1) of the Securities Act of 1933] mandates that the stock be treated as 'securities' subject to coverage of the [federal securities laws]" (471 U.S. at 687). The Court thus held that where an instrument, such as "traditional stock," is plainly within the statutory definition of security, "[t]here is no need * * * to look beyond the characteristics of the instruments to determine whether the [federal securities laws] apply" (*id.* at 690).

The Court recognized that the term "note," also listed in the statutory definition, "may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context" (471 U.S. at 694). The Court, however, "expressly [left] until another day the question whether 'notes' or 'bonds' or some other category of instrument listed in the definition might be shown 'by proving [only] the document itself' " (*ibid.* (quoting *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943) (brackets in original)).

As both petitioners (Pet. 3-5) and respondent (Br. in Opp. 13-16) point out, the courts of appeals have resorted to different tests to determine whether an instrument is a "note" and hence a security under the federal securities laws. In this case, the court of appeals purported to adopt *Landreth*'s suggested analysis and considered, within the particular circumstances presented, whether the Co-Op's notes bear the "usual characteristics of a security." Pet. App. A20. In applying that approach, however, the court of appeals erred in concluding that the demand feature of the notes defeats their characterization as a security. That conclusion, as well as the Eighth Circuit's apparent disregard of the overall investment nature of the Co-Op's public offering, conflicts with the approaches followed by other courts of appeals. Given the disagreement among the lower courts over the

proper treatment of demand notes and the fact that the court of appeals' decision has the effect of withdrawing the protections of the federal securities laws from a particular class of investment instruments, we believe that further review by this Court is warranted.[13]

With respect to the broader disagreement among the courts of appeals over the proper test for determining whether an instrument is a "note," this case may not be an ideal vehicle for this Court's review, since in our view the Co-Op's notes qualify as securities under any of the several tests used for determining whether a note qualifies as a security.[14] Nevertheless, if the Court grants review to resolve the conflict over the proper treatment of the demand feature of the Co-Op's notes, it would clearly be both appropriate and desirable for the Court also to resolve the broader issue that has divided the lower courts.

[13] As a result of the sale of the Co-Op's notes, the Securities and Exchange Commission initiated an enforcement action for violations of the registration and antifraud provisions of the federal securities laws. The parties resolved that enforcement action by agreeing to the entry of consent injunctions. See *SEC* v. *White*, No. CA 86-2015 (W.D. Ark. May 1, 1986); Lit. Release No. 11,011 (Feb. 11, 1986), 35 S.E.C. Docket 84 (Feb. 25, 1986); Lit. Release No. 11,066 (Apr. 17, 1986), 35 S.E.C. Docket 874 (Apr. 29, 1986); Lit. Release No. 11,087 (May 1, 1986), 35 S.E.C. Docket 1076 (May 13, 1986).

It is not uncommon for the Commission to take enforcement action where violations of law have occurred in connection with the public offering of similar notes. See, *e.g.*, *SEC* v. *American Board of Trade, Inc.*, 751 F.2d 529 (2d Cir. 1984) (notes in small denominations maturing in three or six months offered to the general public); *SEC* v. *Bartlett*, 422 F.2d 475 (8th Cir. 1970) (public offering of "bond investment certificates" advertised as withdrawable by purchasers at any time); *SEC* v. *Predator Automotive Concepts, Inc.*, No. 88-255 EDP (E.D. Cal. Feb. 8[illegible] & 13, 1989); Lit. Release No. 11,828 (Aug. 4, 1988), 41 S.E.C. Docket 933 (Aug. 16, 1988); Lit. Release 12,014 (Feb. 24, 1989), 42 S.E.C. Docket 1895 (Mar. 14, 1989) (solicitation through corporate newsletter of investment in six-, nine-, and twelve-month promissory notes raised at least $12 million from approximately 3500 persons); *SEC* v. *Kuhen*, No. CA 3-85-1090-G (N.D. Tex. June 17, 1985); Lit. Release No. 10,788 (June 17, 1985), S.E.C. Docket 605 (July 2, 1985); Lit. Release No. 10,822 (July 16, 1985), 33 S.E.C. Docket 1140 (July 30, 1985) (offering of nine- and twelve-month notes to approximately 340 investors raised $5.6 million); see also note 26, *infra*.

[14] Indeed, petitioners argued as much before the court of appeals. See Pet. for Reh'g 10.

1. a. The court of appeals concluded that the demand feature of the Co-Op's notes disqualified them from the definitional term "note" under the federal securities laws. That conclusion disregards the overriding broad purpose of those laws—to protect persons who purchase instruments offered to the public as investments. *E.g.*, H.R. Rep. No. 85, 73d Cong., 1st Sess. 1-5 (1933); see *United Housing Found.* v. *Forman*, 421 U.S. 837, 849 (1975). Moreover, the term "security" is defined in both the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) to include any "note."[15] On their face, the Co-Op's demand notes meet the statutory definition of a "note," and contrary to the court of appeals' view, a demand feature is not uncharacteristic of a note.[16] Indeed, as courts have observed in analogous situations, " '[i]t is the character of the note, not its maturity date, which determines coverage under * * * the Securities Act of 1933, and the Securities Exchange Act of 1934.' " *C.N.S. Enterprises, Inc.* v. *G. & G. Enterprises, Inc.*, 508 F.2d 1354, 1361 (7th Cir.) (quoting *SEC* v. *Continental Commodities Corp.*, 497 F.2d 516, 525 (5th Cir. 1974)), cert. denied, 423 U.S. 825 (1975); see note 19, *infra*.

To be sure, Section 3(a)(10) of the Exchange Act contains a proviso that excludes from the definition of security "any note

[15] Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), provides that "[t]he term 'security' means any note * * *." Section 2(1) of the Securities Act of 1933, 15 U.S.C. 77b(1), also defines "security" to include any "note."

The Court has "repeatedly ruled that the definitions of 'security' in § 3(a)(10) of the 1934 Act and § 2(1) of the 1933 Act are virtually identical," and has instructed that those terms be so treated. *Landreth*, 471 U.S. at 686 n.1.

[16] The Uniform Commercial Code defines "note" as a negotiable instrument containing an unconditional promise to pay to a specified person or bearer a sum certain, *on demand* or at a definite time. U.C.C. § 3-104 (1977) (emphasis added). See also 11 Am. Jur. 2d *Bills and Notes* § 21, at 50 (1963). Contrary to respondent's suggestion (Br. in Opp. 10), the fact that a dictionary contains separate definitions for "note" and "demand note" shows only that a demand note is one particular type of note, not that it is an entirely different type of debt instrument.

* * * which has a maturity at the time of issuance of not exceeding nine months" (15 U.S.C. 78c(a)(10)). Contrary to respondent's contention (Br. in Opp. 10), however, that proviso does not show that Congress intended to include only term notes, as opposed to demand notes, within the statutory definition. The proviso, which has been construed as co-extensive with its counterpart in the Securities Act,[17] has a limited application in light of the "context" clause.[18] It excludes only those instruments that fit the "general notion" of short-term, high quality commercial paper not generally available for purchase by ordinary investors. *Zeller* v. *Bogue Electric Mfg. Corp.*, 476 F.2d 795, 800 (2d Cir.) (Friendly, J.), cert. denied, 414 U.S. 908 (1973).[19]

[17] Section 3(a)(3) of the Securities Act, 15 U.S.C. 77c(a)(3), exempts from the Act's registration requirements (but not from the definition of a security) certain notes that have a "maturity at time of issuance of not exceeding nine months." The legislative history shows that Congress intended to exempt only "short-term paper of the type available for discount at a Federal Reserve bank and of a type which is rarely bought by private investors." H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933). The Securities and Exchange Commission has long construed the Section 3(a)(3) exemption, commonly known as the "commercial paper" exemption, in this fashion. See Securities Act Release No. 4412 (Sept. 20, 1961), 1 Fed. Sec. L. Rep. (CCH) ¶ 2045 (Apr. 24, 1987).

In light of the virtually identical definitions of "security" in the Securities Act and the Exchange Act, courts have routinely applied the "commercial paper" gloss on the Securities Act's exemption for short-term notes to the Exchange Act's exclusion. See, *e.g.*, *SEC* v. *American Board of Trade, Inc.*, 751 F.2d 529, 538-540 (Friendly, J.) (2d Cir. 1984); *Bauer* v. *Planning Group, Inc.*, 669 F.2d 770, 775-777 (D.C. Cir. 1981); *McClure* v. *First Nat'l Bank*, 497 F.2d 490, 493 n.1 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975).

[18] All 50 definitions in the Exchange Act, 15 U.S.C. 78c(a), and all 15 definitions in the Securities Act, 15 U.S.C. 77b, are preceded by the statutory language "When used in this [chapter], unless the context otherwise requires * * *."

[19] In *Zeller*, 476 F.2d at 800, the court concluded that "the mere fact that a note has a maturity of less than nine months does not take the case out of Rule 10b-5, unless the note fits the general notion of 'commercial paper' * * *." Accord *Zabriskie* v. *Lewis*, 507 F.2d 546, 550 (10th Cir. 1974); *Sanders* v. *John Nuveen & Co.*, 463 F.2d 1075, 1080 (7th Cir.), cert. denied, 409 U.S. 1009 (1972); see L. Loss, *Fundamentals of Securities Regulation* 165-166 n.1 (2d ed. 1988). "[I]t is the character of the note, not its maturity date, which determines coverage" under the securities laws. *SEC* v. *Continental Commodities Corp.*, 497 F.2d 516, 525 (5th Cir. 1974); see also *McClure*, 497 F.2d at 494-495.

Notes such as the Co-Op's demand notes, which are sold primarily to unsophisticated individual investors, plainly do not fit that "general notion." See, *e.g.*, *SEC* v. *American Board of Trade, Inc.*, 751 F.2d 529, 539-540 (2d Cir. 1984) (Friendly, J.).[20] Accordingly, the Co-Op's notes remain within the statutory definition.[21]

b. The court of appeals' treatment of the Co-Op's notes' demand feature also conflicts with the Second Circuit's decision in *Zeller* v. *Bogue Electric Mfg. Corp.*, *supra*. In *Zeller*, the court of appeals expressly concluded that a demand interest-bearing promissory note, issued to a party "in the position of an investor," is a security in the form of a "note" when it does not "fit[] the general notion of 'commercial paper' " (476 F.2d at 800). The court thereafter held that sale of that demand note

[20] In *American Board of Trade*, 751 F.2d at 539-540, Judge Friendly observed that

> [i]t is inconceivable that Congress intended § 3(a)(3) to exempt from registration a periodic public offering of the issuer's own notes to small investors simply because their maturity was less than nine months. It is almost equally unlikely that Congress meant that an issuer soliciting broad public investment in notes issued for general corporate purposes should be able to avoid the anti-fraud provisions of the 1934 Act simply by arranging that they should have "a maturity at the time of issuance of not exceeding nine months."

[21] Respondent suggests in passing (Br. in Opp. 2) that the Co-Op's demand notes are analogous to an interest-bearing savings account or an account with a savings and loan association. Assuming such an analogy were apt, it would not support respondent's position. In *Tcherepnin* v. *Knight*, 389 U.S. 332 (1967), this Court held that withdrawable capital shares in a state-chartered savings and loan association are securities. And, although the Court's reasoning in *Marine Bank* v. *Weaver*, 455 U.S. 551, 558 (1982), would exclude certain accounts from coverage under the securities laws – accounts subject to a comprehensive scheme of federal banking regulation designed to ensure financial soundness and protect depositors against the risk of insolvency, especially federal deposit insurance – the Co-Op's notes certainly do not fall within that category.

could give rise to a claim under Rule 10b-5. *Id.* at 800-801.[22] See, *e.g.*, *Briggs* v. *Sterner*, 529 F. Supp. 1155, 1168 (S.D. Iowa 1981) (demand note held to be a security); *The Fund of Funds, Ltd.* v. *Vesco*, [1976-1977] Fed. Sec. L. Rep. (CCH) ¶ 95,644 90,193-90,195 (S.D.N.Y. July 21, 1976) (same).

Here, the court of appeals mistakenly relied on the statement in *Great Western Bank & Trust* v. *Kotz*, 532 F.2d 1252, 1257 (9th Cir. 1976) (per curiam), that a "demand or short-term note is almost *ipso facto* not a security." First, although we do not agree with the Ninth Circuit's statement, *Great Western* involved a loan transaction between a bank and an individual (on behalf of a corporation), which was secured in part by collateral in the form of a bank account with a $300,000 mandatory minimum balance.[23] That commercial loan arrangement is quite different from the public offering of an investment opportunity at issue here. Second, although ultimately holding that the transaction did not involve a "note" within the meaning of the federal securities laws, the *Great Western* court made clear that, of the numerous factors it considered, no single factor compelled its conclusion. 532 F.2d at 1258; see also note 30, *infra*. The Eighth Circuit therefore erred in assuming that *Great Western* calls for excluding a note from coverage under the securities laws simply because of the note's demand feature.

2. Apart from its erroneous treatment of the demand feature of the Co-Op's notes, the court of appeals' apparent disregard of the overall investment nature of the Co-Op's public

---

[22] Respondent criticizes *Zeller* (Br. in Opp. 8 n.6) for not analyzing the relevance of the demand feature. On the contrary, Judge Friendly viewed the demand note in that case as short term and specifically stated that "the mere fact that a note has a maturity of less than nine months" does not take the case outside the ambit of the federal securities laws (476 F.2d at 800).

[23] In addition, the loan agreement arising out of the *Great Western* loan transaction permitted the bank "to declare default or renegotiate the loan at the faintest sign of insecurity" (532 F.2d at 1258-1259 (footnote omitted)), and consistently referred to the parties as "borrower" and "lender," and to the transaction as a "line of credit" (*id.* at 1259). Furthermore, the bank limited its risk by requiring the borrower to maintain a certain level of consolidated working capital and to use loaned funds only for working capital.

offering cannot be squared with the approaches followed by other courts of appeals. As the district court correctly remarked earlier in this case, "[n]o federal court has ever suggested that a broadscale public offering of notes is a transaction outside the scope of the federal securities acts." *Robertson* v. *White*, 635 F. Supp. 851, 861 (W.D. Ark. 1986).

Contrary to respondent's contention (Br. in Opp. 7), the "critical feature" of the Co-Op's notes is not their demand feature.[24] The key factors are that the Co-Op, as part of a broad offering, sold the notes to the public in small denominations as an investment, and used the proceeds from the sales to finance its day-to-day business needs. In focusing exclusively on the demand feature of the notes, the court of appeals simply disregarded those essential features of the transactions at issue. As a result, the court's analysis is at odds with other courts of appeals' approaches, which recognize that where, as here, a debt instrument is offered to the general public in small denominations as an investment, the instrument is a security, regardless of the length of the instrument's term. See, *e.g.*, *SEC* v. *American Board of Trade, Inc.*, 751 F.2d at 538-540; *Hunssinger* v. *Rockford Business Credits, Inc.*, 745 F.2d 484, 492 (7th Cir. 1984); *United States* v. *Farris*, 614 F.2d 634, 641 (9th Cir. 1979), cert. denied, 447 U.S. 926 (1980); *Lawler* v. *Gilliam*, 569 F.2d 1283, 1286-1287 (4th Cir. 1978); *SEC* v. *World Radio Mission*,

---

[24] Respondent also contends (Br. in Opp. 8-9) that the notes' demand feature, by providing "instant liquidity," eliminates the element of risk essential to an investment transaction covered by the securities laws. But these notes obviously contained elements of risk—the notes were neither insured nor collateralized. Furthermore, the Co-Op marketed the notes' demand feature, not as an aspect of the investment's reduced risk, but rather as a feature for the purchasers' convenience. See, *e.g.*, Pet. C.A. App. 1820 ("NOTES ARE PAYABLE ON DEMAND, so any time you need your money we will write you a check. There is no waiting period." (monthly newsletter)). Moreover, given that the Co-Op advertised the notes as "investments" and announced monthly the current rate of interest, it is apparent that the Co-Op anticipated that noteholders would leave their money with it for extended periods of time. The record confirms that many noteholders in fact did so. See, *e.g.*, Pet. C.A. App. 1491, 1514, 1517, 1526, 1542, 1548, 1558, 1600 (letters of noteholders at time of Co-Op's bankruptcy to trustee in bankruptcy).

544 F.2d 535, 537-540 (1st Cir. 1976); *McClure* v. *First Nat'l Bank*, 497 F.2d 490, 493-494 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975).[25]

3. In our view, the court of appeals plainly misconstrued the application of the federal securities laws by focusing on the notes' demand feature and disregarding the overall investment nature of the Co-Op's public offering. The court of appeals' decision, as shown above, is inconsistent with a number of other federal court decisions, and mistakenly withdraws the protections of the federal securities laws from a class of investment instruments.[26] The Eighth Circuit's decision threatens to undermine the Commission's enforcement efforts over those investment instruments, see note 13, *supra*, and precludes private investors from seeking relief under the antifraud and registration provisions of the federal securities laws.[27] Under these circumstances, we agree with petitioners that further review is appropriate.

4. a. This case also provides the Court with an occasion to resolve the issue left open in *Landreth*, 471 U.S. at 694, concerning the test for determining when an instrument is a "note" within the meaning of the federal securities laws. As petitioners

[25] Compare *Hunssinger* v. *Rockford Business Credits, Inc.*, 745 F.2d 484, 492 (7th Cir. 1984) ("The solicitation of members of the general public seeking a passive return from their capital and the sale to them of units of a larger offering are the hallmarks of an investment transaction.") with *Lino* v. *City Investing Co.*, 487 F.2d 689, 694-695 (3d Cir. 1973) (personal promissory notes are not securities where, among other factors, there was "no public offering of the notes * * * [and] [t]he notes were not procured for speculation or investment").

[26] Contrary to respondent's assertion (Br. in Opp. 6), demand notes are not uncommon investment vehicles. For example, in February 1989, a federal court sentenced a promoter to a term of imprisonment upon his conviction for violating federal securities laws in connection with his issuance of approximately $3.6 million in demand promissory notes to over 100 investors in three states. See *United States* v. *Bloomquist*, CA No. 88-NCR-0056G (D. Utah Mar. 8, 1989), 43 S.E.C. Docket 112 (Mar. 21, 1989); see also note 13 and p. 12, *supra*.

[27] This Court has noted repeatedly that private actions under the federal securities laws are a "necessary supplement" to the Commission's enforcement efforts. See, *e.g.*, *Basic, Inc.* v. *Levinson*, 108 S. Ct. 978, 983 (1988).

(Pet. 3-5) and respondent (Br. in Opp. 13-16) correctly point out, the courts of appeals currently use three different tests for defining a "note": (1) the "commercial-investment dichotomy"; (2) the "risk capital" test; and (3) the "family resemblance" (or "literal") test. See generally 2 L. Loss & J. Seligman, *Securities Regulation* 880 (3d ed. 1989).[28]

The commercial-investment approach analyzes a number of factors to decide the ultimate issue of "whether the plaintiffs are simply borrowers [or lenders] in a commercial transaction who are not protected by the [securities laws] or investors in a securities transaction who are protected." *C.N.S. Enterprises, Inc.*, 508 F.2d at 1359.[29] The risk capital test, which begins with the commercial-investment dichotomy, proceeds to determine "whether the funding party invested 'risk capital.' " *Great*

[28] Most courts of appeals employ the "commercial-investment dichotomy." See, *e.g.*, *Futura Development Corp.* v. *Centex Corp.*, 761 F.2d 33, 40-41 (1st Cir. 1985), cert. denied, 474 U.S. 850 (1985); *C.N.S. Enterprises, Inc.* v. *G & G Enterprises, Inc.*, 508 F.2d 1354, 1357-1362 (7th Cir.), cert. denied, 423 U.S. 825 (1975); *Zabriskie* v. *Lewis*, 507 F.2d 546, 550-552 (10th Cir. 1974); *Bellah* v. *First Nat'l Bank*, 495 F.2d 1109, 1111-1114 (5th Cir. 1974); *Lino* v. *City Investing Co.*, 487 F.2d 689, 693-696 (3d Cir. 1973).

The Ninth Circuit, sometimes joined by the Sixth Circuit, uses the "risk capital" test. See, *e.g.*, *Great Western Bank & Trust* v. *Kotz*, 532 F.2d 1252, 1256-1260 (9th Cir. 1976) (per curiam); see *American Bank & Trust* v. *Wallace*, 702 F.2d 93, 96 (6th Cir. 1983).

The Second Circuit uses the "family resemblance" test. See, *e.g.*, *Exchange Nat'l Bank* v. *Touche Ross & Co.*, 544 F.2d 1126, 1137-1139 (2d Cir. 1976) (Friendly, J.).

[29] These factors include (1) whether the obligations are sold or issued to a single party or to a large class of investors; (2) the characterization of the instruments in the business community, in relevant financial statements, or by the parties themselves; (3) whether the proceeds are to be used to purchase specific assets or services (commercial) or for general financing purposes (investment); (4) the extent of reliance on efforts of others; (5) whether the noteholders are protected by collateral; (6) the number of notes issued, the number of payees, and the dollar amount of the transaction; and (7) the length of the note's term. *C.N.S. Enterprises, Inc.*, 508 F.2d at 1359, 1361. See also Jacobs, *The Meaning of "Security" Under Rule 10b-5*, 29 N.Y.L. Sch. L. Rev. 211, 372-375 (1984) (citing other factors used by various courts).

Western, 532 F.2d at 1257. Like the commercial-investment dichotomy, the risk capital test involves a multi-factor analysis.[10]

The Second Circuit's "family resemblance" test, on the other hand, which is premised on the statutory definition and the prefatory clause, begins with a presumption that the securities laws encompass any note unless "the context otherwise *requires*." 544 F.2d at 1138 (emphasis in original). Accordingly, a note is a security unless it either bears "a strong family resemblance" to certain categories of notes that are clearly outside the scope of the securities laws,[11] or is within the Exchange Act's exclusion for short-term notes, *i.e.*, prime quality commercial paper of the type not generally offered to the public (see *American Board of Trade*, 751 F.2d at 538-540).

b. As one commentator has correctly observed, "[d]espite the diversity of [the three] approaches, they do contain a common core; that is, an issue of notes of whatever maturity sold to more than a few purchasers who are not in the business of loaning money will be deemed securities." Jacobs, *The Meaning of "Security" Under Rule 10b-5*, 29 N.Y.L. Sch. L. Rev. 211,

[10] The risk capital test considers (1) time, (2) collateralization, (3) form of the obligation, (4) circumstances of the issuance, (5) relationship between the amount borrowed and the size of the borrower's business, and (6) contemplated use of the funds. *Great Western*, 532 F.2d at 1257-1258.

[11] *Exchange Nat'l Bank*, 544 F.2d at 1138. In that case, the Second Circuit listed the following examples of notes that are outside the scope of the securities laws (*ibid.*):

> the note delivered in consumer financing, the note secured by a mortage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).

In *Chemical Bank* v. *Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir.) (Friendly, J.), cert. denied, 469 U.S. 884 (1984), the court of appeals added "notes evidencing loans by commercial banks for current operations" to that list of examples.

381-382 (1984). The record in this case clearly shows that the Co-Op offered and sold its unsecured notes to the public in small denominations as an investment opportunity. See, *e.g.*, Pet. App. A70-A72; Pet. C.A. App. 1773-1782, 1905-1920. In our view, therefore, the Co-Op's notes qualify as securities under any of the formulations used by the courts of appeals.

Because we believe that the court of appeals reached the wrong result under any of the three tests used by the lower courts, it follows that this Court, in resolving this case, would not necessarily have to adopt any one of those divergent formulations. Nevertheless, as the court of appeals' decision suggests, the different methods of analysis used by the lower courts are a source of unnecessary confusion and potentially disparate treatment of similar financial instruments. We do not entirely agree with respondent that the "differences [among the three "note" tests] are in methodology, not in results" (Br. in Opp. 13). Thus, it would be both appropriate and desirable for the Court to address the broader issue that has divided the lower courts in the context of determining whether the Co-Op's notes are securities under federal law.

c. Should the Court be inclined to address that issue, we would urge adoption of the Second Circuit's "family resemblance" test.[12] In focusing on the statutory language, that

[12] No party below, including the Commission as amicus curiae on the petition for rehearing, requested the court of appeals to follow the Second Circuit's approach. Nevertheless, it would not be inappropriate for this Court to consider that argument in the first instance. The question presented by petitioners, whether the Co-Op's notes are securities under the federal securities laws (Pet. i), includes the subsidiary issue of the proper test for determining coverage under those laws. See Sup. Ct. R. 21.1(a). Indeed, petitioners, on rehearing in this case, contended that the Co-Op's notes qualified as securities under each of the three tests used by the courts of appeals. Pet. for Reh'g 10. Furthermore, the prudential considerations that ordinarily weigh against the Court's addressing an argument not squarely presented below do not obtain here. Federal courts have grappled for years over the proper test for determining whether an instrument is a "note." Thus, there is no doubt that the issue has been adequately addressed by the lower courts. Cf. *Carlson* v. *Green*, 446 U.S. 14, 17 n.2 (1980); *Blonder-Tongue Laboratories, Inc.* v. *University of Illinois Found.*, 402 U.S. 313, 320 n.6 (1971).

test mirrors the analysis this Court applied in *Landreth*, 471 U.S. at 685-692, and provides useful guidance and a degree of certainty regarding the status of particular types of notes under the securities laws. Indeed, as Judge Friendly has pointed out, the other "note" tests inject a variety of factors into the analysis "without any instructions as to relative weights." *Exchange Nat'l Bank*, 544 F.2d at 1137. And the analytical difficulties arising from different tests, evident in the case law, are compounded by courts' reserving the right to alter their formulation of those tests as different cases arise. See *ibid.*; see also Jacobs, *supra*, 29 N.Y.L. Sch. L. Rev. at 371-372, 377.[11]

---

[11] Because the Co-Op's notes fall within the term "note" in the statutory definition of security, those instruments need not also satisfy the investment contract test of *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946); cf. *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 691-692 (1985) (*Howey* test has no application to stock, an instrument listed in the statutory definitions of security). Accordingly, the court of appeals also erred in subjecting the notes to scrutiny under this residual test for determining coverage under the securities laws.

Even if that test governed here, the court of appeals misapplied that test. First, the record shows that the notes were issued to and purchased by an unsophisticated public as investments. Thus, contrary to the court of appeals' conclusory reasoning, the notes certainly satisfied the "investment" element of the investment contract test. Second, the court of appeals erred in concluding that the noteholders' expected return, a fixed rate of interest, may not satisfy the "profit" element. See, *e.g.*, *Gary Plastic Packaging Corp.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 240-241 (2d Cir. 1985); *El Khadem* v. *Equity Securities Corp.*, 494 F.2d 1224, 1229 (9th Cir.), cert. denied, 419 U.S. 900 (1974); but see *Union Planters Nat'l Bank* v. *Commercial Credit Business Loans*, 651 F.2d 1174, 1184-1185 (6th Cir.), cert. denied, 454 U.S. 1124 (1981). Excluding from the protection of the securities laws those instruments in which investors are promised a fixed return, whether in the form of interest or lump-sum payments, would be contrary to this Court's directive that the "statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *Howey*, 328 U.S. at 301.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

WILLIAM C. BRYSON
Acting Solicitor General

THOMAS W. MERRILL
Deputy Solicitor General

MICHAEL R. LAZERWITZ
Assistant to the Solicitor General

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

MARTHA H. MCNEELY
Special Counsel

EVA MARIE CARNEY
Attorney
Securities and Exchange Commission

MAY 1989

U.S. GOVERNMENT PRINTING OFFICE: 1989—241 609/00283

SUPPLEMENTAL

BRIEF

Supreme Court, U.S.
FILED
MAY 24 1989
JOSEPH F. SPANIOL, JR.
CLERK

(5)

No. 88-1480

IN THE
Supreme Court of the United States
OCTOBER TERM, 1988

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, as Representatives of a Class of Note Holders,

Petitioners,

v.

ARTHUR YOUNG & CO.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

SUPPLEMENTAL BRIEF FOR THE RESPONDENT

John Matson
(Counsel of Record)
Carl D. Liggio
Elizabeth B. Healy
Jacqueline B. Steele
277 Park Avenue
New York, NY 10172
(212) 407-2358
Kathryn A. Oberly
2000 Pennsylvania Ave., N.W.
Washington, D.C. 20006
Michael H. Mashburn
P.O. Box 1921
Fayetteville, AR 72702

Attorneys for Respondent

9 pp

TABLE OF AUTHORITIES

CASES — PAGE

American Bank & Trust Co. v. Wallace, 702 F.2d 93 (6th Cir. 1983).....5

Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d 426 (9th Cir. 1978).....4

Briggs v. Sterner, 529 F. Supp. 1155 (S.D. Iowa 1981).....2

C.N.S. Enterprises, Inc. v. G.&G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).....5

Fund of Funds, Ltd. v. Vesco, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,644 (S.D.N.Y. July 21, 1976).....2

Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976).....4, 5

Hunssinger v. Rockford Business Credits, Inc., 745 F.2d 484 (7th Cir. 1984).....5

Landreth Timber Co. v. Landreth, 471 U.S. 861 (1985).....4

Marine Bank v. Weaver, 455 U.S. 551 (1982).....4

Schlifke v. Seafirst Corp., 866 F.2d 935 (7th Cir. 1989).....5

Union Nat'l Bank v. Farmers Bank, 786 F.2d 881 (8th Cir. 1986).....4

United States v. Bloomquist, CA No. 88-NCR-0056G (D. Utah Mar. 8, 1989).....2, 3

Watt v. Alaska, 451 U.S. 259 (1981).....3

Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).....1

OTHER AUTHORITIES

Comment, *Commercial Notes and Definition of "Security" Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 NEB. L. REV. 478 (1973).....3, 5

Jacobs, *The Meaning of "Security" Under Rule 10b-5*, 29 N.Y.L. SCH. L. REV. 211 (1984).....5

No. 88-1480

IN THE
Supreme Court of the United States
OCTOBER TERM, 1988

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, as Representatives of a Class of Note Holders,

Petitioners,

v.

ARTHUR YOUNG & CO.,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

SUPPLEMENTAL BRIEF FOR THE RESPONDENT

Respondent submits this supplemental memorandum in response to the Brief for the United States and the Securities and Exchange Commission as Amici Curiae.

Although the Government has accurately framed the issue before the Court as "the proper treatment of the demand feature of the Co-Op's notes," U.S. Br. at 8, it has offered no compelling reason for the grant of *certiorari* in this case. It has cited only one other court of appeals case on the demand note question, *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973). That case is not in conflict with the decision below because, as Arthur Young has pointed out, *Zeller* predates the present case by more

than fifteen years, arose in a very different factual setting, provided no analysis of the demand note issue and involved an instrument that the Second Circuit did not really treat as a demand note. *See* Br in Opp. at 8 n.6.

The Government asserts that "demand notes are not uncommon investment vehicles," U.S. Br. at 14 n.26, but it offers no support for that proposition. It cites, in addition to *Zeller,* only one recent criminal case involving demand notes, *see United States v. Bloomquist*, CA No. 88-NCR-0056G (D. Utah Mar. 8, 1989), cited at 14 n.26, and two earlier civil cases, *Briggs v. Sterner*, 529 F. Supp. 1155 (S.D. Iowa 1981), and *Fund of Funds, Ltd. v. Vesco*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,644 (S.D.N.Y. July 21, 1976). *See* U.S. Br. at 12. The Government's effort to characterize term note cases as "similar" to those involving demand notes, *see, e.g.*, U.S. Br. at 8 n.13, cannot mask the fact that there is no body of case law on the only question it agrees is squarely before the Court -- the proper treatment of a demand feature in a promissory note.

The fact that, in more than 50 years, the courts have so rarely considered the demand note issue bespeaks its lack of significance. Whether or not the Eighth Circuit was correct in holding the demand notes here at issue not to be securities -- and Arthur Young, of course, argues that it was -- there is nothing in the Government's brief demonstrating that this Court should devote its time and resources to a question of such narrow applicability and interest.

The Government has, in fact, made virtually no effort to show any broad significance to the

demand note issue. It asserts that enforcement efforts of the Securities and Exchange Commission will be undermined by this decision, but it cites only one enforcement case involving demand notes. In that case, which was decided after the Eighth Circuit decision in this case, the Government obtained a conviction of the seller of demand notes. *See United States v. Bloomquist,* CA No. 88-NCR-0056G (D. Utah Mar. 8, 1989), cited in U.S. Br. at 14 n.26.

The Government's repeated assertion of the Eighth Circuit's "apparent disregard of the overall investment nature of the Co-Op's public offering," U.S. Br. at 7; *see also id.* at 9, 12, 13, 14 & n.25, 18 n.33, does not implicate important policy issues but only suggests error in this particular case. That is not a reason for granting *certiorari*. *See, e.g., Watt v. Alaska*, 451 U.S. 259, 273-276 (1981) (Stevens, J., concurring). Equally important, the Government's assertion that the demand notes here were "investments" simply assumes the ultimate question. As Arthur Young has pointed out, the instant liquidity inherent in demand notes is, in fact, totally foreign to the concept of "investment." *See, e.g.*, Comment, *Commercial Notes and Definition of "Security" Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 NEB. L. REV. 478, 521-23 (1973).

To focus, as the Government does, only on the number of purchasers of an instrument creates a risk of the "securitization" and, hence, the federalization of any fraud scheme where a written instrument is used with respect to a large number of people. As the Eighth Circuit noted in this case, Congress did not intend "to provide a broad federal

remedy for all fraud. . . ." Pet. App. A19, quoting *Union Nat'l Bank v. Farmers Bank*, 786 F.2d 881, 884 (8th Cir. 1986). *Accord Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

Although the Government acknowledges that the question here is focused on demand notes, it points to a broader issue that this Court has never considered -- the general criteria for determining when a note is a security. *See Landreth Timber Co. v. Landreth* 471 U.S. 861, 894 (1985). However, it concedes that "this case may not be an ideal vehicle for this Court's review" of that broader question. U.S. Br. at 8. This is so, in part, because of the lack of typicality of the demand feature present in this case. *See, e.g., Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976); *cf. Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc.*, 583 F.2d 426 (9th Cir. 1978) ("An acceleration clause is not a typical characteristic of a security. . . .").

As the Government's own citations confirm, *see, e.g.*, U.S. Br. 8 n.13, most notes that are litigated are term notes and the issue most often presented is whether a lending institution has, in a particular case, engaged in a traditional lending transaction or, because of the nature of the note and the circumstances of its issuance, has made a term investment in the maker of the note. The notes at issue in those cases are never of a demand nature and the controlling issues in those cases are not present here.

Arthur Young has argued that the differences among the various tests in the circuits for determining when a note is a security relate only to methodology and not to result. *See* Br. in Opp. at

13-15; *American Bank & Trust Co. v. Wallace*, 702 F.2d 93, 95 (6th Cir. 1983). The Government's response is tepid at best: "We do not entirely agree with respondent that the "differences [among the three 'note' tests] are in methodology, not in results." U.S. Br. at 17, quoting Br. in Opp. at 13.[1]

The most the Government can say is that the different analytical approaches of the courts of appeals could create "*potentially* disparate treatment of similar financial instruments." U.S. Br. at 17 (emphasis added).[2] Arthur Young respectfully

---

1 The Government quotes one article as emphasizing the "common core" of the different approaches, *see* U.S. Br. at 16, quoting Jacobs, *The Meaning of "Security" Under Rule 10b-5*, 29 N.Y.L. SCH. L. REV. 211, 381-82 (1984), and then uses the Jacobs passage to suggest that any time there are "more than a few purchasers who are not in the business of loaning money," the instrument will be a security. *Id.* Jacobs was, in fact, discussing only term instruments. Other commentators have noted that the demand nature of an instrument is antithetical to the making of an investment and, hence, the purchasing of a security. *See, e.g.*, Comment, *supra*, 52 NEB. L. REV. at 521-23. The Government ignores the fact that the tests used in most of the circuits make the duration of the note an important factor in determining whether it is a security. *See, e.g., Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1257-58 (9th Cir. 1976) (risk capital test); *C.N.S. Enterprises, Inc. v. G.&G. Enterprises, Inc.*, 508 F.2d 1354, 1361 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975) (investment/commercial test).

2 It is striking that the only reported citation of the decision below is *Schlifke v. Seafirst Corp.*, 866 F.2d 935 (7th Cir. 1989). In that case, the Seventh Circuit cited with approval both the decision below and its own prior decision in *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984) -- the decision that both the Government and Petitioners have portrayed as the most antagonistic to the Eighth Circuit's approach to promissory notes. *See* U.S. Br. at 13; Pet. at 6-7 n.9.

suggests that, even if that were true, this Court should wait until that potentiality is realized, the Government having been unable to point to instances where it has already occurred.

If and when a true conflict among the circuits presents itself in a context that has broader applicability than the isolated instance of demand notes, the Court may wish to review the issue. In the meantime, review would be both premature and unwise; were the Court to accept the Government's invitation to tackle the broad issue of notes-as-securities in this case, it would be doing so in a factual vacuum that would make the provision of meaningful guidance for the lower courts most unlikely.

For the reasons stated above and in the Brief in Opposition previously filed, the petition for a writ of *certiorari* should be denied.

New York, New York
May 24, 1989

Respectfully submitted,

John Matson
(Counsel of Record)
Carl D. Liggio
Elizabeth B. Healy
Jacqueline B. Steele
277 Park Avenue
New York, NY 10172
(212) 407-2358
Kathryn A. Oberly
2000 Pennsylvania Ave., N.W.
Washington, D.C. 20006
Michael H. Mashburn
P.O. Box 1921
Fayetteville, AR 72702
Attorneys for Respondent

JOINT

APPENDIX

Supreme Court, U.S.
FILED
JUL 27 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-148

In The

Supreme Court of the United States

October Term, 1989

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, As Representatives of a Class of Note Holders,

Petitioners,

— v.

ARTHUR YOUNG & CO.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

JOINT APPENDIX

JOHN R. MCCAMBRIDGE*
GRIPPO & ELDEN
20 South Clark Street
Chicago, Illinois 60603
(312) 704-7700
Counsel for Petitioners

JOHN MATSON*
ARTHUR YOUNG & COMPANY
277 Park Avenue
New York, New York 10172
(212) 407-2358
Counsel for Respondent

*Counsel of Record

PETITION FOR CERTIORARI FILED MARCH 2, 1989
CERTIORARI GRANTED JUNE 12, 1989

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

TABLE OF CONTENTS

Page

RELEVANT DOCKET ENTRIES

In the United States District Court for the Western District of Arkansas 1

In the United States Court of Appeals for the Eighth Circuit 2

EXHIBITS

Form of the Demand Notes Issued by the Farmer's Co-Op (C.A. Appendix 1818) 4

Sample "Co-Op Investment Program" Advertisement, Dated April 1982 (C.A. Appendix 1873) 5

Letter from Morril H. Harriman to William B. Brady, Arkansas Securities Commission, with enclosed Offering Statement and Consolidated Balance Sheet, Dated August 5, 1983 (C.A. Appendix 1772-82) 6

Declaration of Sandra K. Robb, Dated June 7, 1985 (Exhibits to Declaration omitted) (C.A. Appendix 1811-17) 20

DECISIONS AND ORDERS

Order and Memorandum Opinion Granting Plaintiffs' Motion for Summary Judgment, United States District Court for the Western District of Arkansas, Dated June 10, 1986 ..... *

Amended Judgment Order after Jury Verdict, United States District Court for the Western District of Arkansas, Dated April 27, 1987 27

---

* *See* Appendix to the Petition for a Writ of Certiorari at A-32.

TABLE OF CONTENTS – Continued

Page

Judgment Regarding Interest Rate Applied to Amended Judgment Order, United States District Court for the Western District of Arkansas, Dated October 15, 1987 31

Memorandum Opinion, United States Court of Appeals for the Eighth Circuit, Dated September 2, 1988..... **

Order Denying Petition for Rehearing and Petition for Rehearing *En Banc*, and Dissenting Opinion, United States Court of Appeals for the Eighth Circuit, Dated December 2, 1988 ..... ***

Order Granting Petition for a Writ of Certiorari, Supreme Court of the United States, Dated June 12, 1989 33

** *See* Appendix to the Petition for a Writ of Certiorari at A-8.

*** *See* Appendix to the Petition for a Writ of Certiorari at A-1.

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., *et al.*, Plaintiffs,

v.

JACK E. WHITE, *et al.*, Defendants.

Consolidated Cases No.
85-2044, 85-2096, 85-2155, 85-2259

RELEVANT DOCKET ENTRIES

Date	*Filed By*	*Description*
2/14/85	Plaintiffs	COMPLAINT.
6/14/85	Plaintiffs	MOTION For Summary Judgment, MEMORANDUM In Support, And EXHIBITS Thereto.
4/18/86	Defendant Arthur Young	MEMORANDUM *Amicus Curiae* With Respect To Whether The Co-Op Demand Notes Are Securities.
5/5/86	Plaintiffs	MEMORANDUM In Response To Memorandum Of Arthur Young With Respect To Whether The Co-Op Demand Notes Are Securities.
5/19/86	Defendant Arthur Young	REPLY MEMORANDUM *Amicus Curiae* With Respect To Whether The Co-Op Demand Notes Are Securities.

6/10/86	Court	ORDER and MEMORANDUM OPINION Granting Plaintiffs' Motion For Summary Judgment, Determining, *Inter Alia*, Notes To Be Securities Under Arkansas Law.
10/15/86	Court	ORDER and MEMORANDUM OPINION, Determining, *Inter Alia*, Notes To Be Securities Under Federal Law.
2/5/87	Court	JUDGMENT ORDER After Jury Verdict.
4/27/87	Court	AMENDED JUDGMENT ORDER After Jury Verdict.
10/15/87	Court	JUDGMENT Regarding Interest Rate To Be Applied To Amended Judgment Order.

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

87-1726 WA, 87-1727 WA, 87-1803 WA
Consolidated

THOMAS E. ROBERTSON, Jr., *et al.*, and BOB REVES, *et al.*,

Plaintiffs, Cross-Appellants, and Appellees,

v.

ARTHUR YOUNG & COMPANY,

Defendant, Appellant, and Cross-Appellee,

v.

HAL BREWER, *et al.*,

Third-Party Defendants and Appellees.

RELEVANT DOCKET ENTRIES

Date	*Filed By*	*Description*
9/2/88	Court	OPINION Reversing Denial Of Arthur Young's Motion For Judgment J.N.O.V. And Denying The Class' And Trustee's Cross-Appeals.
9/16/88	Robertson, *et al.* and Reves, *et al.*	PETITION For Rehearing With Suggestions For Rehearing *En Banc*.
9/16/88	Arkansas Securities Department	BRIEF As *Amicus Curiae* Supporting Petition For Rehearing.
9/27/88	Securities and Exchange Commission	BRIEF As *Amicus Curiae* Supporting Petition For Rehearing.
9/29/88	Court	ORDER That Arthur Young & Co. File A Response To Petition For Rehearing.
10/14/88	Arthur Young	BRIEF Of Appellant In Opposition To Petition For Rehearing.
12/2/88	Court	ORDER Denying Petition For Rehearing and Rehearing *En Banc*; DISSENTING OPINION.

Form of the Demand Notes
Issued by the Farmer's Co-Op

Acct.# _____

No. 12778

Due On Demand

_____, 19___

On Demand _____ after date, for value received, I, we, or either of us, promise to pay to the order of

_____

$ _____

Cr. _____

Bal. _____

_____ DOLLARS,

negotiable and payable without defalcation or discount at Van Buren, Arkansas _____ with interest from Date _____ until paid, at the rate of _____ per cent, per annum; and if not paid when due, the interest is to become part of principal and bear a like rate of interest. No extension of time of payment with or without our knowledge, by receipt of interest or otherwise, shall release us, or either of us, from the obligation of payment. The makers and endorsers of the note hereby waive demands, notice and protest, and in event payment is not made at maturity, we further agree to pay attorney fees incurred in enforcing the collection of this note, or any part of it. "The satisfaction of the above obligation of Farmers Co-op of Arkansas and Oklahoma evidenced by this demand note, is NOT insured by any agency of the State or Federal government nor is any savings insurance provided. This obligation is backed only by the assets of Farmers Co-op of Arkansas and Oklahoma."

All accrued interest payable _____ and annually thereafter.

P. O. _____ Farmers CO-OP of Ark. & Okla.

P. O. _____ By _____

BEST AVAILABLE COPY

BEST AVAILABLE COPY

Sample
"Co-Op Investment Program"
Advertisement,
Dated April 1982

COOP

INVESTMENT PROGRAM

PAYING
14% INTEREST

The CO-OP will continue to review the money market for future adjustment.

For Complete Details
Ask These Members of Your CO-OP Team

VAN BUREN ..... Jack White
Kirit Goradia — Eddie Joe Smith

CAULKSVILLE ..... Jack Soller

SALLISAW .... Harold Wallace - Dennis McClure

MUSKOGEE .....Jerry Finley, Robert Tracy

STIGLER ..... Sam Pendergrass

YOUR CO-OP has more than $11,000,000 in assets to stand behind your investments. The investment is not Federal Insured but it is . . . Safe . Secure . . . and available when you need it. Interest is computed to the day of withdrawal.

EXAMPLES ON 14% INTEREST ON DEMAND NOTES

NOTE	INT. MONTHLY	INT ANNUALLY
$ 2,000 00	$ 23 33	$ 280 00
3,000 00	35 00	420 00
4,000 00	46 67	560 00
5,000 00	58 33	700 00
6 000 00	70 00	840 00
7,000 00	81 67	980 00
8 000 00	93 33	1,120 00
9,000 00	105 00	1,260 00
10 000 00	116 67	1,400 00

NOTES ARE PAYABLE ON DEMAND, so any time you need your money we will write you a check. There is no waiting period.

Farmers Co-op of AR-OK

Drawer U, Industrial Pk., VAN BUREN, ARKANSAS
CAULKSVILLE, ARKANSAS
805 West Cherokee, SALLISAW, OKLAHOMA
724 Mill Street, MUSKOGEE, OKLAHOMA
STIGLER, OKLAHOMA

1873

Morril H. Harriman

Attorney at Law

322 Main Street, Van Buren, Arkansas 72956

(501) 474-1701

August 5, 1983

Mr. William B. Brady, Attorney
Arkansas Securities Commission
#1 Capitol Mall – 4B-206
Little Rock, AR 72201

Re: Farmers Co-Op of Arkansas and Oklahoma

Dear Mr. Brady:

Enclosed please find the Offering Statement of Farmers Co-Op of Arkansas and Oklahoma.

After you have had time to review the same, I would appreciate your contacting me concerning the Commission's acceptance or suggestions.

Sincerely,

/s/ Morril Harriman
Morril Harriman

MH:clw

Enclosure

OFFERING STATEMENT

Farmers Co-Op of Arkansas and Oklahoma
(The "Co-Op")

Van Buren, Arkansas
(Mailing Address: P. O. Drawer U
Van Buren, Arkansas 72956)

AN ARKANSAS AGRICULTURAL COOPERATIVE

DEMAND NOTES

THESE SECURITIES ARE OFFERED PURSUANT TO EXEMPTIONS FROM REGISTRATION UNDER THE ARKANSAS SECURITIES ACT AND THE SECURITIES ACT OF 1933. NEITHER THE ARKANSAS SECURITIES DEPARTMENT NOR THE SECURITIES AND EXCHANGE COMMISSION HAS PASSED UPON THE VALUE OF THESE SECURITIES, MADE ANY RECOMMENDATIONS AS TO THEIR PURCHASE, APPROVED OR DISAPPROVED THE OFFERING, OR PASSED UPON THE ADEQUACY OR ACCURACY OF THIS OFFERING STATEMENT. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL.

---

(1) The Demand Notes are being offered and sold by the Co-Op through certain designated employees of the Co-Op only to its members. No commission or other remuneration is being paid directly or indirectly to such employees in connection with the offer and sale of the Demand Notes.

(2) The Co-Op Demand Notes are sold for a minimum purchase price of $100. There is no restriction upon amounts above this minimum which may be added to the

original note or for which members may purchase additional notes. The interest rate payable upon the note is redetermined monthly based upon current market rates with interest payable or compounded monthly, quarterly, semi-annually or annually depending upon the account balance and/or wishes of the investor. The investment is *NOT* insured by any agency of the state or federal government nor is any type of savings or investment insurance provided. The obligation and investment are backed only by the assets of the Co-Op.

No person has been authorized to give any information or to make any representations other than those contained in this Offering Statement in connection with the offer contained in this Offering Statement, and, if given or made, such information or representations must not be relied upon as having been authorized by the Co-Op. This Offering Statement is not an offer to sell, or a solicitation of an offer to buy, any of the Demand Notes offered hereby to any person who is not a member of the Co-Op. This prospectus does not constitute an offering or solicitation in respect of these Demand Notes in any jurisdiction in which such offer or solicitation would be unlawful. Neither the delivery of this Offering Statement nor any sale made hereunder shall under any circumstances create any implication that there has been no change in the affairs of the Co-Op since the date hereof.

TABLE OF CONTENTS

[Omitted in Printing]

Prior to making an investment decision respecting the Demand Notes offered hereby, a prospective pur-

chaser should carefully review and consider the entire Offering Statement. Designated employees of the Co-Op are available to discuss with prospective purchasers any matter set forth in this Offering Statement or any other matter relating to the Demand Notes in order that prospective purchasers may have available to them all information relating to their prospective purchase.

THE CO-OP

Farmers Co-Op of Arkansas and Oklahoma is an agricultural cooperative which originally was founded under the laws of the State of Arkansas in 1946 under the name of Crawford County Farm Bureau. The Co-Op has since that date continually expanded its services and sale of products to its members and patrons of western Arkansas and eastern Oklahoma. In the year 1982, the Co-Op had gross sales of over forty-four million dollars through its facilities located in Van Buren and Caulksville, Arkansas, and Muskogee, Sallisaw and Stigler, Oklahoma.

The Co-Op business is in two basic areas: cooperative farm supply operations and cooperative marketing. Various product groups appear within these areas: petroleum and petroleum products, fertilizer and agricultural chemicals, feed, equipment, supplies and services, food marketing, grain marketing and storage.

The Co-Op, through its wholly owned subsidiary, White Flame Fuels, Inc., is also engaged in the production of fuel alcohol. This operation is currently being leased to JEW, Inc., which has assumed the total operational and

marketing responsibilities for the facility commonly known as the "gasahol plant."

The management office of the Co-Op is located on Industrial Park Road in Van Buren, Arkansas, which is the office of the Co-Op's general manager and the offices of the heads of the various cooperative departments. The Co-Op's books and records are also kept at this location.

The Co-Op is governed by a nine member board of directors who serve for a term of three years, three such positions being elected yearly at the Co-Op's annual meeting. It is the board's responsibility to hire a general manager who is in charge of the day to day operations of the Co-Op and who is also in charge of employing further personnel of the Co-Op.

Accompanying this statement are copies of a Comparative Statement of Operations and Consolidated Balance Sheet which is condensed from the Co-Op's 1981 and 1982 certified audit by Arthur Young & Company.

THE DEMAND NOTE

The Co-Op investment program for members, commonly known as the Demand Note Program, has been in existence for more than fifteen years. The notes are unsecured obligations of the Co-Op and bear a varying rate of interest which is redetermined monthly based upon current market rates. The interest upon the notes is payable or compounded monthly, quarterly, semi-annually or annually depending upon the account balance and/or wishes of the investor. The principal amount of

the note, plus any accrued interest, is payable to the investor upon demand.

The Demand Notes are not registered with the Arkansas Securities Commissioner, Little Rock, Arkansas, under the Arkansas Securities Act. The Co-Op is making this offer without registration of the Demand Notes with the Securities and Exchange Commission under the Securities Act of 1933 and the Trust Indenture Act of 1939. The Co-Op has filed a proof of exemption from registration under Section 14(a) (12) of the Arkansas Securities Act for the Demand Notes offered hereby. In the judgment of the Co-Op, the offer and sale Demand Notes are exempt from registration under the Securities Act of 1933 pursuant to the exemption from registration provided by Section 3(a) (5) of that Act.

In the judgment of the Co-Op, the Certificates of Membership, Notices of Allocated Reserves to members and other patrons of the Co-Op do not constitute "securities" as defined by Section (13) (1) of the Arkansas Securities Act and Section 2(1) of the Securities Act of 1933.

Investors within the Demand Note Program must be members of the Co-Op. The holder of a Demand Note may at any time invest additional monies within the investment program for so long as he or she remains a qualified Co-Op member. The investor should again be aware that satisfaction of the Demand Note is NOT insured by any agency of the State or Federal government nor is any savings insurance provided to the investor. The obligation of the Demand Note is backed ONLY by the assets of Farmers Co-Op of Arkansas and Oklahoma.

FACTORS TO BE CONSIDERED

Purchase of the Demand Notes involves financial consideration. Prospective purchasers should consider carefully, among other factors, the following:

1. *Lack of Independent Review.* This offering is being made by the Co-Op through certain designated employees and will not be reviewed by an independent selling agent.

2. *Lack of Segregated Fund.* There is no segregated fund for the repurchase or redemption of the Demand Notes. Accordingly, purchasers of Demand Notes must consider the net earnings of the Co-Op as the principal source of funds for payment of interest and for repayment of principal upon demand. As of December 31, 1983, there was on deposit with the Co-Op Demand Notes in the total amount of $11,693,011.

3. *Subordination.* The Demand Notes are unsecured, general obligations of the Co-Op and are not enforceable against the personal assets of any member, Officer or Director of the Co-Op. Payment of principal and interest to holders of the Demand Notes will be subordinated to obligations to secured creditors.

4. *Business Risks.* The agricultural industry is a highly competitive business. Expenses and income may be subject to substantial fluctuations. The Co-Op's operational success depends upon a number of factors including supply and demand, financing, promotion, management and acceptance by both producers and consumers of agricultural products. Unforeseen occurrences

may arise which may materially affect the Co-Op's operations.

5. *Registration Exemption*. It is the further judgment of the Co-Op that Certificates of Membership, Membership Agreements, Notices of Allocated Reserves issued to members and patrons of the Co-Op do not constitute "securities" as defined by Section 2(1) of the Securities Act of 1933.

6. *Membership Requirement*. Purchase of Demand Notes are available only to members of the Co-Op. In the event the holder's membership were terminated, his right to purchase or add to any existing Demand Note would be terminated.

APPLICATION OF PROCEEDS

The proceeds from the sale of Demand Notes are used throughout the operations of the Co-Op, including, but not limited to, purchase of inventory, equipment, fixtures and capital improvements which may be necessary to the Co-Op's facilities. The funds derived from the Demand Note Program are in no manner segregated or utilized for one particular use or need.

MANAGEMENT

Directors and Officers

Pursuant to the Articles of Incorporation and By-Laws of the Co-Op, the management of the business and affairs of the Co-Op is vested in its Board of Directors which consists of nine members. Directors are elected at the annual meeting of the Co-Op's members for three

year terms, with three positions being so elected each year. Vacancies in the Board of Directors, other than by expiration of term, are filled by a majority vote of the Directors remaining in office. Directors to fill such vacancies are appointed for the unexpired term of those whom they succeed.

The Directors and Officers of the Co-Op and the positions held by each are as follows:

[Omitted in Printing]

The President, Vice-President and Directors of the Co-Op reside in the central western counties of Arkansas and eastern central counties of Oklahoma and are active member-patrons of the Co-Op. The General Manager of the Co-Op is Fred A. Howard, who is responsible for day-to-day operations. Any transactions between the Co-Op and Directors of the Co-Op are conducted on the same basis as transactions with other member-patrons of the Co-Op.

COMPETITION

The Co-Op competes with several agricultural cooperatives and grain storage facilities located within western Arkansas and eastern Oklahoma, one such grain storage and purchasing facility having been completed within Van Buren, Arkansas, during the summer of 1983.

With respect to further operations, the Co-Op is unable to predict the effect on the business and margins of the Co-Op of changes in general economic conditions which may affect the Co-Op, such as changes in commodity and agricultural prices, freight rates, the cost and

availability of materials, labor and transportation, the development of competitive products, and changes in legislation and governmental regulations, including modification of tax laws applicable to agricultural cooperatives.

REGULATION

The Co-Op's storage facilities are licensed under the United States Warehouse Act. Pursuant to that Act, the Department of Agriculture is authorized to examine the books, records, papers and accounts of the Co-Op as they relate to the condition, contents, operation and business of the Co-Op's facilities.

In addition, the Co-Op's facilities must comply with a number of other federal and state statutes, including applicable requirements of the Occupational Safety and Health Act. The Co-Op believes that it is in compliance with all current regulations affecting its business. See "Tax Matters".

MEMBERSHIP IN THE CO-OP

Pursuant to the By-laws of the Co-Op, any person, firm or corporation who is engaged in the production of agricultural products, as well as eligible cooperative associations, may, subject to the approval of the Board of Directors, become a member of the Co-Op by paying to the Co-Op a membership fee of not less than $5.00 and by agreeing to abide by the By-laws of the Co-Op. In return for payment of the membership fee and acceptance of the

terms of the membership, such person, firm or corporation will be issued a Certificate of Stock which evidences membership in the Co-Op and the right to participate in the affairs of the Co-Op. The Certificate of Stock is not assignable, not transferable and not refundable.

Pursuant to the Articles of Incorporation of the Co-Op, the voting rights of members of the Co-Op must be equal, and each member is entitled to one vote only upon each matter submitted to vote at any meeting of the Co-Op members. If a member becomes a nonproducer of farm products, such action automatically suspends all voting and other membership privileges of the member, and the member is notified of such suspension. In addition, the voting rights of any member who violates any part of the By-laws, or rules and regulations of the Co-Op, or who performs an act of disloyalty to the Co-Op, may be suspended by a majority vote of the Board of Directors. Notice of such cancellation must be given the member at his last address appearing in the records of the Co-Op.

Before a membership may be terminated, the Board of Directors is required to conduct a meeting for the purpose of hearing and receiving evidence of the charges preferred against the member, or concerning a member's eligibility to be a member. At such meeting the member may present witnesses and be heard in person or by counsel in answer thereto; and the person bringing the charges against the member shall have the same opportunity. Notice of the meeting, containing a statement of the charges preferred against the member, shall be mailed to such member at least ten days prior to the date of meeting.

Pursuant to the By-laws of the Co-Op, the annual meeting of the membership shall be held at a location where accomodations can be found within a period of six months after the end of the Co-Op's fiscal year. The actual date of meeting is determined and set by the Board of Directors. Special meeting of the stockholders may be called when requested by at least ten percent of the shareholders. Only members in good standing have the right to vote at membership meetings with each member having only one vote per issue.

At the end of each fiscal year, the Board of Directors, as soon as practicable, are required to have a certified audit of the books and accounts of the Co-Op. This audit for fiscal years 1981 and 1982 has been prepared by the firm of Arthur Young & Company. (See Statement of Operations and Consolidated Balance Sheet.)

TAX MATTERS

During 1980 the Internal Revenue Service issued the Co-Op a notice of deficiency totaling $1,244,610 for the years 1973 through 1976. In the opinion of the Co-Op and outside tax counsel, several of the positions taken by the Internal Revenue Service are erroneous and the Co-Op has petitioned the U.S. Tax Court for a trial and hearing concerning this notice of deficiency. It is, therefore, impossible to predict the eventual outcome or the ultimate tax liability, if any, which might result in this litigation.

The Internal Revenue Service is presently conducting an investigation of the federal income tax returns of the

Co-Op for the years 1977 through 1980. No formal proposals or assessments have been received at this time.

SUBSIDIARY

On September 10, 1982, White Flame Fuels, Inc., a wholly owned subsidiary of the Co-Op, leased its gasahol production facilities to JEW, Inc. The lessee is to pay all operating expenses of the facilities, with rent being paid to the Co-Op of fifty percent of the lessee's net profits. In its notes to the 1982 audit, the auditor points out that due to production limitations and prevailing market conditions, there is a doubt cast on the recovery of the Co-Op investment within the gasahol production plant.

LEGAL PROCEEDINGS

Management of the Co-Op is not presently aware of any legal proceedings, except ordinary routine litigation incidental to the business, to which the Co-Op is a party.

ARTICLES OF INCORPORATION AND BY-LAWS

Accompanying this Offering Statement are copies of the Co-Op's Articles of Incorporation and By-laws as last amended prior to the date of this Offering Statement. The Articles of Incorporation and By-laws of the Co-Op set forth in detail such matters as the responsibilities of Officers and Directors, the rights of members and the calculation of distributions to patrons. Prospective Co-Op members and/or patrons are encouraged to read the Articles of Incorporation and By-laws before becoming members and/or patrons of the Co-Op.

The following financial information was condensed from Arthur Young & Company's Annual Audit.

Statement of Operations
Year Ended December 31, 1982 and 1981

	Farmers Co-op* 1982	Gasohol Plant† 1982	Consolidated‡ 1982	Consolidated‡ 1981
SALES	$ 43,199,444	$ 1,845,580	$ 44,837,168	$ 48,230,884
COST OF GOODS SOLD & PRODUCTION COST	39,899,552	2,482,632	39,677,814	42,989,632
GROSS OPERATING INCOME (LOSS)	3,299,581	(636,372)	3,159,390	5,240,731
OPERATING EXPENSES:				
Salaries, Wages, & Commissions	2,467,974	16,000	2,484,570	2,483,829
Interest	1,881,733	-	1,881,933	2,273,190
Operating & Office Supplies	824,816	-	824,816	834,848
Depreciation	344,208	3,107	347,415	349,878
Bad Debts	334,930	34,787	369,817	814,780
Utilities & Telephone	291,972	1,324	293,496	287,485
Taxes	291,814	27,825	319,639	291,338
Maintenance & Repairs	267,865	33,640	301,505	361,861
Insurance	218,878	9,588	221,846	218,708
Advertising	151,534	-	151,534	157,867
Other	226,875	821	227,696	431,438
TOTAL OPERATING EXPENSES	7,293,799	108,136	7,402,452	8,240,888
OPERATING LOSS	(994,218)	(884,529)	(1,843,144)	(1,881,958)
OTHER INCOME:				
Patronage Dividend	108,589	-	108,589	267,858
Interest & Finance Charge	187,177	-	187,177	275,348
Rent	81,990	23,990	84,990	63,232
Other	57,887	7,182	61,018	71,003
TOTAL OTHER INCOME	384,673	31,172	425,845	728,631
LOSS BEFORE PATRONAGE DISTRIBUTION	(583,543)	(823,757)	(1,217,299)	(1,171,308)
DISTRIBUTION TO PATRONS	-	-	-	253,210
NET LOSS	$ (583,543)	$ (823,757)	$ (1,217,299)	$ (1,424,518)

*Farmers Co-op of Arkansas and Oklahoma
†Gasohol Plants Funds, Inc.
‡After Elimination of Inter-Company Transactions.

Consolidated Balance Sheet
December 31, 1982 and 1981

ASSETS	1982	1981
CURRENT ASSETS:		
Cash	$ 1,080,148	$ 902,525
Trade Receivables	1,871,483	2,487,183
Prepaid Expenses	288,195	348,081
Inventories	3,853,793	3,741,819
TOTAL CURRENT ASSETS	6,926,529	8,477,609
INVESTMENTS & OTHER ASSETS:		
Investments in Regional Cooperatives	2,963,696	2,948,434
Other Investments	67,264	351,478
TOTAL INVESTMENTS & OTHER ASSETS	3,030,960	3,301,912
PROPERTY, PLANT & EQUIPMENT:		
Land & Improvements	974,136	960,636
Buildings & Improvements	8,168,668	8,226,367
Furniture & Fixtures	805,648	729,671
Automotive, Machinery & Other	3,370,170	3,077,170
Gasohol Plant Facilities	4,537,548	4,527,548
	18,756,368	18,180,618
Less Accumulated Depreciation	5,831,531	4,689,279
NET PROPERTY, PLANT & EQUIPMENT	2,924,753	7,509,397
TOTAL ASSETS	$ 17,127,366	$ 19,868,368
LIABILITIES & MEMBERS' EQUITY		
CURRENT LIABILITIES:		
Notes Payable	$ 1,218,316	$ 2,880,535
Trade Accounts Payable	2,015,854	2,325,163
Other Accrued Payable	340,478	561,801
Demand Deposits of Patrons	11,843,911	12,194,807
TOTAL CURRENT LIABILITIES	15,318,605	17,880,648
LONG TERM DEBT	621,471	1,166,137
TOTAL LIABILITIES	15,941,240	19,048,743
MEMBERS' EQUITY:		
Common Stock	123,218	122,872
Allocated Savings	2,603,629	3,116,366
Retained Earnings (Deficit)	(1,540,106)	(418,771)
TOTAL MEMBERS' EQUITY	1,186,746	2,819,625
TOTAL LIABILITIES & MEMBERS' EQUITY	$ 17,127,366	$ 19,868,368

AT 11421

FARMING IS A GOOD LIFE
CO-OP MAKES IT BETTER

BEST AVAILABLE COPY

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., As Trustee of the Farmer's Co-Op of Arkansas & Oklahoma, Inc., etc.,	)	
Plaintiff,	)	
and	)	
BOB REVES, *et al.*,	)	No. 85-2044
Intervening plaintiffs,	)	
v.	)	
JACK E. WHITE, *et al.*,	)	
Defendants.	)	

DECLARATION OF SANDRA K. ROBB

I, Sandra K. Robb, hereby declare under penalty of perjury that the following statements are true and correct:

1. I am presently office manager of the Farmer's Co-Op of Arkansas & Oklahoma, Inc. ("Co-Op"). I have worked at the Co-Op since September, 1975. Prior to becoming office manager I was an administrative assistant/bookkeeper. I am familiar with the Co-Op's books and records.

2. Jack E. White was General Manager of the Co-Op at all times between April 5, 1980 and August, 1982. Basically, he was the person in charge of its affairs. White had an office at the Co-Op facility in Van Buren, and was the highest-ranking officer or employee of the Co-Op with such an office. The only persons in the Co-Op organization senior to him were the directors (some of whom

also held the titles of President, Vice-President, Secretary, and Treasurer, as described below).

3. Kirit Goradia was Office Manager and Controller of the Co-Op at all times between April 5, 1980 and February 23, 1984. He reported to White while White was General Manager.

4. The following persons (among others) were directors of the Co-Op during at least the periods specified:

Person	*Period*
Hal Brewer	April 5, 1980 to March 24, 1983
Waldo Price	April 5, 1980 to Feb. 19, 1981
Truman O. Boatright	April 5, 1980 to March 24, 1983
Hugh Winfrey, Jr.	April 5, 1980 to April 17, 1981
Charles Bane	April 5, 1980 to April 17, 1980
Robert Plunkett	April 5, 1980 to April 17, 1981
Ralph McClure	April 5, 1980 to Feb. 16, 1984
Jimmy Don Gooch	April 5, 1980 to April 17, 1981
Jerry Metzger	April 5, 1980 to May 20, 1982
Don Sebo	April 17, 1980 to Aug. 27, 1982
Joe Wayne Harris	April 17, 1981 to Feb. 23, 1984
James Willis	April 17, 1981 to Feb. 23, 1984
Dan Ray Core	April 17, 1981 to Feb. 23, 1984
Harold Davis	June 17, 1982 to Feb. 23, 1984

5. In addition, Hal Brewer was President of the Co-Op from April 5, 1980 until June 17, 1982; Dan Ray Core was President from June 17, 1982 until February 23, 1984; Truman O. Boatright was Secretary of the Co-Op during the period specified next to his name; Hugh Winfrey, Jr. was Treasurer of the Co-Op during the period specified next to his name; and Waldo Price was Vice-President of

the Co-Op during the period specified next to his name. James B. Willis was Secretary from September 26, 1983 through the Co-Op's bankruptcy. None of these individuals had an office at the Co-Op.

6. Throughout the period from September 1, 1979 to February 23, 1984, the Co-Op's principal place of business was located in Van Buren, Arkansas. It had other places of business in Sallisaw, Oklahoma; Muskogee, Oklahoma; Stigler, Oklahoma; and Caulksville, Arkansas.

7. The Co-Op issued demand notes to the public throughout the time I was employed there, until it filed for bankruptcy on February 23, 1984. The form of note used by the Co-Op while I was employed there is attached to this declaration as *Exhibit 1*. These notes were issued to members of the Co-Op and until 1983, to non-members as well. The purchasers included residents of at least the states of Arkansas and Oklahoma.

8. I took over the job of keeping the records relating to the demand note program from Mary Jeffers in about November, 1983. These records were kept in a series of large binders containing sheets for each holder, organized alphabetically, and listing all transactions involving that holder. These records were prepared and maintained in the regular course of the Co-Op's business. Entries were made in them after demand note transactions, using the second copy of the check or note prepared in connection with the transactions. Entries were also made periodically to show the amount of interest each holder was entitled to.

9. The Co-Op issued demand notes in any denomination requested, with a minimum of $100.

10. The rate of interest that the Co-Op paid on the demand notes varied. The current rate was announced each month in the Co-Op's newsletter.

11. Between April 1, 1980 and the Co-Op's bankruptcy, the Co-Op sent, through the United States Mails, a newsletter to each member at the beginning of each month. The newsletters were mailed from the printer, which was located in Van Buren, Arkansas. Mr. White and the directors listed above, other than Mr. Sebo, were members of the Co-Op according to its records. There was also a membership in the name of Sebo Farms.

12. Each of the newsletters, except that for February, 1984, contained an advertisement for the demand notes. *Group Exhibit 2* to this declaration includes accurate copies of all advertisements published between April 1, 1980 and the Co-Op's bankruptcy on February 23, 1984, except for those in two issues that were not in the Co-Op's files. The text of each advertisement during this period was substantially identical except for (a) the rate of interest paid on the demand notes, which varied, (b) the names of the Co-Op's managerial employees, and (c) the amount of the Co-Op's assets. All of the advertisements stated that the demand notes were "investments."

13. The Co-Op newsletters also printed the names of its current officers and directors. These announcements are also included in *Group Exhibit 2*.

14. The Co-Op's records show that the demand note program began in 1958-59. They also show that the number of persons currently having balances in demand note amounts is 1,685. Many other persons held demand

notes at various times between the inception of the program and the Co-Op's bankruptcy.

15. As General Manager of the Co-Op, Jack E. White had supervisory responsibility for the Co-Op's demand note program. Among other things, White was responsible for setting the rate of interest paid on the demand notes. While he was at the Co-Op, he signed the notes. White also answered questions about the program from purchasers and prospective purchasers of notes.

16. As Office Manager and Controller of the Co-Op, Kirit Goradia also had supervisory responsibility for the demand note program. He signed demand notes in the absence of the General Manager. He participated in determining the rate of interest that would be paid on the notes. In addition, Mr. Goradia was in charge of the Co-Op office staff, which took in some of the money from demand note purchasers and issued all of the notes.

17. The Co-Op continued issuing demand notes until its bankruptcy on February 23, 1984. At no time after I took over keeping the records relating to the program was I told to stop issuing or selling demand notes to Co-Op members.

18. I was never instructed to inform purchasers, prospective purchasers, or holders of demand notes that the Co-Op was insolvent or in danger of financial collapse. Prior to the Co-Op's bankruptcy, I was never told or learned of anything that suggested that the demand notes were not a safe and secure investment, or that the Co-Op would not be able to pay them back.

19. I was never instructed to furnish purchasers, prospective purchasers, or holders of demand notes with a booklet describing the Co-Op or the demand notes. In particular, I was never told to furnish anyone with *Exhibit 3* to this declaration, or any other document that was similar in form to *Exhibit 3* or entitled "offering statement." I did not in fact furnish any such documents to anyone.

20. I was never instructed to furnish purchasers, prospective purchasers, or holders of demand notes with the full financial statements of the Co-Op, such as *Exhibit 4* to this declaration. The only financial information about the Co-Op that I provided in connection with the sales of demand notes were the condensed financial statements, such as *Exhibit 5* to this declaration.

21. To the best of my knowledge and belief, the Co-Op's demand notes were not held by Federal Reserve Banks.

22. Whenever demand notes were presented for payment, the Co-Op made a check out to the persons whose names appeared on the demand note.

23. The following documents are accurate copies of pages from the books containing the minutes of meetings of the Co-Op's Board of Directors: 916-01; 000005-1; 000007-1; 000010-1; 000011-1; 00013; 00014; 00017 and 000017-1; 00018 and 000018-1; 00020; 00021; 00023; 00024 and 000024-1; 00027 and 000027-1; 00028 and 000028-1; 00029 and 000029-1; 00030 and 000030-1; 00032; 00035; 00036; 00039; 00040 and 000040-1; 00041 and 000041-1; 00045; 00065 and 000065-1 and -2; 00063; 00062 and 000062-1; 00060 and 000060-1; 00059 and 000059-1; 00057

and 000057-1; 00054-55 and 000054-1 and 55-1; 00053; 00050; 00046; 00068 and 000068-1; and 00069. They were maintained in the Co-Op's files.

Executed at Van Buren, Arkansas, on June 7, 1985.

/s/ Sandra K. Robb
SANDRA K. ROBB

[Exhibits to Declaration Omitted in Printing]

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as Trustee of the Farmer's Co-Op of Arkansas & Oklahoma, Inc.; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds — PLAINTIFFS

v.

Consolidated Cases No. 85-2044, 85-2096, 85-2155, 85-2259

JACK E. WHITE, ET AL. — DEFENDANTS

AMENDED JUDGMENT ORDER
(Filed April 27, 1987)

This cause having been tried before this court and the jury having rendered its verdict, the court orders that judgment be entered as follows:

Definitions

1. Plaintiff *Thomas E. Robertson, Jr.*, ("Robertson") is the Trustee in Bankruptcy of the Farmer's Co-Op of Arkansas and Oklahoma, Inc. ("Co-Op").

2. The plaintiff *Class* is that group of individuals who purchased demand notes from the Co-Op between

the dates of April 22, 1982, and February 23, 1984. Bob Reves, Frances Graham and Robert H. Gibbs are the Class representatives.

3. Defendant *Ball, Mourton & Adams* is a law partnership whose partners include E.J. Ball, Kenneth R. Mourton and Stephen E. Adams. It refers to and includes its predecessor firm, Ball & Mourton. A judgment against the partners and the partnership is effective against Stephen E. Adams only to the extent of his interest.

4. Defendant *Arthur Young* means Arthur Young & Company, four of whose partners at the times in question were defendants Harry C. Erwin, Billy Joe Cabaniss, Jr., Joseph F. Drozal, Jr., and Charles M. Hanson.

5. *Third party defendants* are Hal Brewer, Waldo Price, Truman O. Boatright, J.O. McClure, Hugh Winfrey, Jr., M.V. Creech, Charles Bane, E.H. Pritchett, Jr., Robert Plunkett, Ralph McClure, Jimmy Don Gooch, Jerry Metzger, W.J. Rimmer, Don Sebo, Joe Wayne Harris, James Willis, Dan Ray Core, Harold Davis, Jay Freeman, Jay Neal, Jr., George Wagnon, Raymond (Jack) Clark and Eddie Joe Smith.

JUDGMENT

Judgment shall be entered as follows:

1. As to Count III, alleging violations of the Arkansas and federal securities laws, a new trial is granted defendants Ball, Mourton & Adams, and E.J. Ball and Kenneth R. Mourton, unless the Trustee accepts, within ten (10) days of the filing on this judgment, a remittitur on the verdict found by the jury in the sum of

$982,000. If the Trustee accepts the remittitur, then judgment shall enter in the sum of $1,750,000 under both state and federal claims. The verdict and judgment under the state securities law shall bear prejudgment interest at the rate of six percent (6%), but no interest shall be collected on the federal law claim. The matter of fees and costs shall be taken up on motion after the filing of this judgment, in accordance with the opinion filed contemporaneously herewith. As a credit against the judgment amount, the defendants Ball, Mourton & Adams, and Ball and Mourton, shall be allowed the sum of either $2,692,000 on the state law claim or $1,030,656 on the federal law claim, conditional on the approval of settlements with the Trustee and the Class, now set for March 30-31, 1987. The court shall later set a schedule for plaintiffs to file a bill of costs and a petition to establish the amount of prejudgment interest and fees due. The Trustee shall be allowed the larger net recovery under this Count, after allowance of credits and establishment of interest, fees and costs.

2. As to Count VI, Arthur Young is ordered to pay to the Class $6,121,652.94, plus prejudgment interest, attorney fees (only on the state securities claims) and costs, under both state and federal claims, subject to a credit in the amount of $5,744,780, conditional on settlements with the Class being approved. The judgment shall bear prejudgment interest and carry an award of fees under the state act, and prejudgment interest under the federal securities laws claims. Questions relating to the eligibility for fees under the federal claim, and the amount of any fees, shall be later determined. The court shall set a schedule for plaintiffs to file a bill of costs and a petition to establish the amount of prejudgment interest

and fees due. The Class shall be allowed the larger net recovery under this Count, after allowing credits and determining fees, interest and costs.

3. As to Count VII, judgment is entered for the Trustee against Ball, Mourton & Adams, and Ball and Mourton, in the amount of $51,980, plus costs, which shall be reduced in the sum of any unused credits given in paragraph 1.

4. Judgment is entered for defendants and against plaintiffs on Counts I, II, IV and XI.

5. Judgment is entered for third party defendants on all third party claims.

6. Judgment is entered for the plaintiffs on all counterclaims.

7. Pursuant to Rule 54b, the court finds that there is no just reason to delay enforcement of or appeal of this judgment.

IT IS SO ORDERED.

/s/ H. Franklin Waters
United States District Judge

Date: Apr. 23, 1987.

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as Trustee of the Farmer's Co-Op of Arkansas & Oklahoma, Inc.; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds — PLAINTIFFS

v.

Consolidated Cases No. 85-2044, 85-2096, 85-2155, 85-2259

JACK E. WHITE, ET AL. — DEFENDANTS

JUDGMENT
(Filed October 15, 1987)

On this 14th day of October, 1987, upon consideration of the matters set forth in the court's letters to the attorneys for the parties dated September 4, 1987, and October 14, 1987, which are attached hereto and made a part hereof, and for the reasons set forth in such letters, the court hereby enters judgment in favor of the "Class" as that term is more particularly defined in the court's Amended Judgment Order filed April 27, 1987, against Arthur Young, on Count VI of the complaint filed herein, in the total amount of $2,451,513.17. Such judgment shall be considered to be entered as of April 27, 1987, and shall

bear interest from such date at the rate of 6.3 percent per annum until paid. The court's Amended Judgment Order entered on April 27, 1987, shall be considered to be amended to the extent necessary to accomplish the foregoing.

IT IS SO ORDERED.

/s/ H. Franklin Waters
United States District Judge

SUPREME COURT OF THE UNITED STATES
OFFICE OF THE CLERK
WASHINGTON, D.C. 20543

June 12, 1989

Mr. Gary M. Elden
Grippo & Elden
20 So. Clark St.
Chicago, IL 60603

Re: Bob Reves, et al.,
v. Arthur Young & Co.
No. 88-1480

Dear Mr. Elden:

The Court today entered the following order in the above entitled case:

The petition for a writ of certiorari is granted.

Very truly yours,

/s/ Joseph F. Spaniol, Jr.,
Joseph F. Spaniol, Jr., Clerk

PETITIONER'S

BRIEF

Supreme Court, U.S.
FILED
JUL 27 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-1480

In The

Supreme Court of the United States

October Term, 1989

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, As Representatives of a Class of Note Holders,

Petitioners,

v.

ARTHUR YOUNG & CO.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONERS

Robert R. Cloar
Court Plaza, Suite 102
51 South 6th Street
Fort Smith, Arkansas 72901
(501) 783-1186

Gary M. Elden
John R. McCambridge*
Jay R. Hoffman
Gripto & Elden
20 South Clark Street
Chicago, Illinois 60603
(312) 704-7700

Attorneys for Petitioners

*Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

45pp

QUESTION PRESENTED

Whether uninsured and uncollateralized demand notes offered to the public, described by the issuer as "investments," and sold to numerous passive investors are securities under the federal securities laws.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF CONTENTS	ii
TABLE OF AUTHORITIES	iv
OPINIONS BELOW	1
JURISDICTIONAL GROUNDS	1
STATUTE INVOLVED	1
STATEMENT OF THE CASE	2
SUMMARY OF ARGUMENT	13
ARGUMENT	14
I. INTRODUCTION	14
II. THIS COURT SHOULD RESOLVE THE CONFLICT AMONG THE COURTS OF APPEALS AND SPECIFY THE TEST FOR DETERMINING WHETHER A NOTE IS A "SECURITY."	17
A. The Eighth Circuit Erroneously Applied The *Landreth* Test For Stock To An Issuance Of Notes	17
B. In Examining The Context In Which The Notes Were Issued, The Eighth Circuit Mistakenly Applied The *Howey* Test	19
C. Among The Note Tests Developed By The Courts Of Appeals, The Class Favors The Second Circuit's "Family Resemblance" Test	22
D. Alternatively, The Class Requests Adoption Of The Majority "Investment Vs. Commercial" Test	25

TABLE OF CONTENTS – Continued

	Page
1. The Co-Op Notes Evidence Investments And Therefore Are Securities.	27
2. Notes Payable On Demand May, Under Appropriate Circumstances, Be Securities	28
E. The "Risk Capital" Test Is A Reformulation Of The *Howey* Test And Thus Should Not Apply To Notes	31
III. THE ACTS' EXEMPTIONS FOR SHORT-TERM NOTES APPLY ONLY TO COMMERCIAL PAPER, AND NOT TO PUBLICLY-OFFERED INSTRUMENTS LIKE THE CO-OP NOTES	33
IV. IF THIS COURT DOES NOT ADOPT A UNIFORM TEST FOR NOTES, THEN THE COURT SHOULD HOLD THAT NOTES OFFERED TO THE PUBLIC AS "INVESTMENTS," SOLD TO MANY PASSIVE INVESTORS, AND PROTECTED BY NEITHER COLLATERAL NOR INSURANCE ARE SECURITIES	36
CONCLUSION	37

TABLE OF AUTHORITIES

Page

CASES

American Bank & Trust v. Wallace, 702 F.2d 93 (6th Cir. 1983) 31

American Bankers Ass'n v. SEC, 804 F.2d 739 (D.C. Cir. 1986) 19

Baurer v. Planning Group, Inc., 669 F.2d 770 (D.C. Cir. 1981) 21

Briggs v. Sterner, 529 F. Supp. 1155 (S.D. Iowa 1981) 21, 29

C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975) 26, 27, 29

Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984) 22, 23, 24

Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976) 21, 22, 23, 25, 32

Fund of Funds, Ltd. v. Vesco, [1976-1977] Fed. Sec. L. Rep. (CCH) ¶ 95,644 (S.D.N.Y. July 21, 1976) 29

Futura Dev. Corp. v. Centex Corp., 761 F.2d 33 (1st Cir.), *cert. denied*, 474 U.S. 850 (1985) 25, 26, 31

Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230 (2d Cir. 1985) 25

Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976) 31, 32, 33

H.J. Inc. v. Northwestern Bell Tel. Co., 109 S. Ct. 2893 (1989) 12

TABLE OF AUTHORITIES – Continued

Page

Holloway v. Peat, Marwick, Mitchell & Co., Nos. 87-1486, 87-1490 (10th Cir. July 11, 1989) (available on Westlaw) ..... *passim*

Hunssinger v. Rockford Business Credits, Inc., 745 F.2d 484 (7th Cir. 1984) 21, 22, 25, 27, 28

Johnson v. Computer Technology Services, Inc., 670 F. Supp. 1036 (D.D.C. 1987) 21

Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) ..... *passim*

Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973) 26

Marine Bank v. Weaver, 455 U.S. 551 (1982) ... 14, 19, 36

McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) .. 25, 27, 28, 29

Ruefenacht v. O'Halloran, 737 F.2d 320 (3d Cir. 1984), *aff'd sub nom. Gould v. Ruefenacht*, 471 U.S. 701 (1985) 19

Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972) 28, 35, 36

Schlifke v. Seafirst Corp., 866 F.2d 935 (7th Cir. 1989) 21

SEC v. American Board of Trade, 751 F.2d 529 (2d Cir. 1984) 22, 23, 35, 36

SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) 17–

SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974) 29

SEC v. W.J. Howey Co., 328 U.S. 293 (1946) ..... *passim*

TABLE OF AUTHORITIES – Continued

Page

SEC v. White, No. CA 86-2015 (W.D. Ark. May 1, 1986) 7

Securities Industry Ass'n v. Board of Governors of Federal Reserve System, 468 U.S. 137 (1984) 19, 34

Underhill v. Royal, 769 F.2d 1426 (9th Cir. 1985)..... 31

United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975) 14, 15, 22

United States v. Attaway, 211 F. Supp. 682 (W.D. La. 1962) 29

Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974)...26, 28

Zeller v. Bogue Electric Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973)..... 29, 34, 35

STATUTES

15 U.S.C. § 77b..... 19

15 U.S.C. § 77b(1) 14

15 U.S.C. § 77c(a)(3) 33

15 U.S.C. § 77c(a)(5)(B)(i) 6

15 U.S.C. § 78c(a)(10)..... 1, 14, 33

18 U.S.C. §§ 1961-68..... 8

28 U.S.C. § 1254(1) 1

Ark. Stat. Ann. §§ 23-42-101 to -508..... 6

Ark. Stat. Ann. § 23-42-503(c)-(d) 6

TABLE OF AUTHORITIES – Continued

Page

OTHER AUTHORITIES

L. Loss, *Fundamentals of Securities Regulation* (1988) 31

L. Loss & J. Seligman, *Securities Regulation* (1989) 15, 19, 32, 35

Comment, *Commercial Notes and Definition of "Security" Under Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 Neb. L. Rev. 478 (1973) 26

Jacobs, *The Meaning of "Security" Under Rule 10b-5*, 29 N.Y.L. Sch. L. Rev. 211 (1984)..... 26, 32, 36

Securities Act Release No. 4412 (Sept. 20, 1961), 1 Fed. Sec. L. Rep. (CCH) ¶ 2045 (Apr. 24, 1987) 35

H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933) 15, 34

S. Rep. No. 47, 73d Cong., 1st Sess. (1933)..... 34

S. Rep. No. 792, 73d Cong., 2d Sess. (1934) 14

OPINIONS BELOW

The panel opinion of the U.S. Court of Appeals for the Eighth Circuit is reported at 856 F.2d 52 (Pet. A 8). The dissenting opinion on rehearing is reported at 856 F.2d 55 (Pet. A 1). The summary judgment opinion of the U.S. District Court for the Western District of Arkansas is reported at 635 F. Supp. 851 (in pertinent part, Pet. A 32).

JURISDICTIONAL GROUNDS

On September 2, 1988, the Eighth Circuit reversed the judgment of the district court denying Arthur Young & Co.'s motion for judgment notwithstanding the verdict. On December 2, 1988, a majority of the court of appeals denied the petition for rehearing en banc. On March 2, 1989, the Petition for Writ of Certiorari was filed. By order dated June 12, 1989, this Court granted the Petition pursuant to 28 U.S.C. § 1254(1).

STATUTE INVOLVED

15 U.S.C. § 78c(a)(10)

(a) When used in this chapter, unless the context otherwise requires –

* * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust

certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

STATEMENT OF THE CASE[1]

The Co-Op

The Farmer's Co-Op of Arkansas and Oklahoma, Inc. ("Co-Op") is an agricultural cooperative organized under Arkansas law. (JA 9.)[2] During the late 1970s and early

[1] Petitioners are Bob Reves, Robert H. Gibbs, and Frances Graham, as representatives of a class of note holders. Respondent is Arthur Young & Co.

[2] Citations in this brief observe the following format. Citations to the Joint Appendix on Writ of Certiorari are in the form "JA ___." Citations to the Court of Appeals Joint Appendix are in the form of "CAJA ___." Citations to the Appendix to the Petition for a Writ of Certiorari are in the form "Pet. A ___." Citations to the trial transcript are by volume and page in the form "Trans. ___:___."

1980s, the Co-Op had over 23,000 members, most of them located in rural western Arkansas and eastern Oklahoma. (Pet. A 72 (reported at 635 F. Supp. 851, 863); JA 9.) The Co-Op provided farm supplies and marketing services, trading in products such as petroleum, fertilizer, chemicals, feed, and farm equipment. (JA 9.)

In 1980, the Co-Op expanded its operations by acquiring White Flame Fuels, Inc. ("White Flame"), a company which owned and operated a gasohol plant. (JA 9-10.) The Co-Op acquired White Flame from Jack White, the Co-Op's own general manager. At the time, White Flame was losing roughly one hundred thousand dollars per month. (Trans. VII:255-56, XIV:171.)

On February 23, 1984, the Co-Op filed for bankruptcy under Chapter 11 of the Bankruptcy Code. (CAJA 1985 (reported at 633 F. Supp. 954, 960).)

The Co-Op's Sale Of Demand Notes

In 1959, the Co-Op began to raise funds by selling interest-bearing promissory notes that were payable on demand. The Co-Op used the proceeds of these note sales to finance its day-to-day operations, to make capital purchases, and to fund its acquisition of the gasohol plant. (CAJA 1937 (633 F. Supp. at 962); CAJA 1985.) This case involves the status under the federal securities laws of those notes issued by the Co-Op.

The Co-Op promoted its sale of demand notes throughout its principal area of operations. The Co-Op prominently touted its note program as an investment opportunity in every issue of "Your Co-Op News," the

monthly newsletter sent to all members. (Pet. A 70 (635 F. Supp. at 863); *see also* CAJA 1819-904.) The advertisements, which were identical in all material respects every month, were headed

CO-OP INVESTMENT PROGRAM

and stated in the text that

> YOUR CO-OP has more than $11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] Insured but it is . . . Safe . . . Secure . . . and available when you need it.

(JA 5 (ellipses in original); *see also* CAJA 1819-904 (other advertisements).)

The Co-Op offered and sold its demand notes to members and non-members alike (Pet. A 72 (635 F. Supp. at 863); JA 22), issuing them in any denomination requested, with a minimum of $100. (JA 22.) The notes were neither insured nor collateralized. (Pet. A 72-73 (635 F. Supp. at 863).) They paid a variable rate of interest, which the Co-Op's management reviewed every month and then adjusted in accordance with its analysis of market conditions. (JA 8, 23-24.) The Co-Op announced the currently-prevailing rate in each newsletter (JA 23; *see also* JA 5; CAJA 1820-903), and promised in its advertisements "to review the money market for future adjustment." (JA 5; CAJA 1820-903.) The interest on the notes was either paid to the note holder or retained by the Co-Op and compounded "depending upon the account balance and/or the wishes of the investor." (JA 10.) When the Co-Op filed for bankruptcy, more than 1600 persons held demand notes, which they had purchased for over $10 million. (Pet. A 73 (635 F. Supp. at 863).)

Arthur Young And The Co-Op

In November 1981, the Co-Op hired Arthur Young & Co. ("Arthur Young") as its new outside auditors. (CAJA 1093.) On April 22, 1982, Arthur Young presented to the Co-Op board of directors a set of financial statements for the year ending December 31, 1981, and a report on those financial statements. (Trans. XII:99-100; CAJA 234-55.) The balance sheet prepared by Arthur Young carried the gasohol plant at a value of $4.5 million and depicted the Co-Op as having a net worth of $2.6 million. (CAJA 238-39.)[3]

On May 27, 1982, the Co-Op held its 1982 Annual Meeting. The Notice of Meeting sent to members included condensed financial statements[4] (CAJA 230-31), as well as an agenda promising a "Financial Report" by an Arthur Young partner. (CAJA 231.) At the Annual Meeting, Arthur Young's top partner in Arkansas made a presentation and answered various questions from the

---

[3] To arrive at a carrying value of $4.5 million for the gasohol plant, Arthur Young assumed that Jack White had never owned White Flame and that the Co-Op always did. (*See* Trans. IX:214-15, X:21.) Had Arthur Young treated White Flame as having been acquired by the Co-Op, it would have had to carry the gasohol plant its fair market at value of $1 million or less. (*See* Trans. IV:97-98, XIV:170-79.) With the gasohol plant carried at its proper value, the Co-Op would have been exposed as having a negative net worth. (*See* CAJA 238-39.)

[4] The "condensed" statements carried the gasohol plant at the inflated value assigned by Arthur Young and represented the Co-Op as having a positive net worth. (*See* Trans. XII:107-09.)

floor concerning the Co-Op's financial condition, including the impact of the gasohol plant. (Trans. XI:100-10.)

Arthur Young also audited the Co-Op for the year ending December 31, 1982. (CAJA 256-77.) As part of the Notice of the 1983 Annual Meeting, Co-Op members received financial statements declaring, "The following financial information was condensed from Arthur Young & Company's Annual Audit." (JA 19.)[5] Again at the 1983 meeting, an Arthur Young partner presented the Co-Op's "Financial Report." (CAJA 232; Trans. XI:149-52.)

Enforcement Efforts Of State And Federal Regulators

The Arkansas Securities Department ("Department") regarded the Co-Op's demand notes as securities subject to regulation under the Arkansas Securities Act ("State Act").[6] (CAJA 1748-56.) The State Act provides that notes issued by agricultural cooperatives must be either registered or exempted from registration.[7] In 1976 and 1979, the Co-Op complied with the State Act by filing for and receiving exemptions. (CAJA 1801-10.)

---

[5] Arthur Young's new financial statements continued to carry the gasohol plant at its inflated value and to depict the Co-Op as solvent. (*See* CAJA 2[illegible]7.)

[6] Ark. Stat. Ann. §§ 23-42-101 to -508.

[7] Ark. Stat. Ann § 23-42-503(c)-(d); *see also* 15 U.S.C. § 77c(a)(5)(B)(i) (1933 Act's exemption for securities issued by farmer's cooperative organization that is exempt from taxation).

After the 1979 exemption lapsed in 1980, the Co-Op neither registered its notes nor obtained exemptions. (CAJA 1985.) Finally, late in 1983, the Co-Op filed a formal request with the Department "that certain demand notes issued by the Co-Op be classified as an exempt security." (CAJA 1764-65.) The Co-Op also provided the Department with a draft Offering Statement. (JA 7-19; *see* Trans. X:142-44.) In the draft, the Co-Op recites its history and business, describes the demand notes as "securities," refers to the purchase of a note as "an investment decision," describes the marketing of the notes as "the Co-Op investment program," and refers to purchasers of notes as "investors." (JA 7-18.) At the Co-Op's request, Arthur Young reviewed the Offering Statement; the only change it proposed was the deletion of all references to Arthur Young. (CAJA 1251-60; Trans. X:143-44.)

The Co-Op's note program also was the subject of federal enforcement efforts. In January 1986, the Securities and Exchange Commission ("SEC") brought an enforcement action against the Co-Op's former management. The SEC alleged that the defendants, through the sale of Co-Op demand notes, violated the registration and antifraud provisions of the federal securities laws. The SEC's action concluded with the entry of consent injunctions.[8]

---

[8] *See SEC v. White*, No. CA 86-2015 (W.D. Ark. May 1, 1986); Lit. Release No. 11,011 (Feb. 11, 1986), 35 S.E.C. Docket 84 (Feb. 25, 1986); Lit. Release No. 11,066 (Apr. 17, 1986), 35 S.E.C. 874 (Apr. 29, 1986); Lit. Release No. 11,087 (May 1, 1986), 35 S.E.C. Docket 1076 (May 13, 1986).

Proceedings In The District Court

On February 14, 1985, Thomas E. Robertson, Jr. filed an action in the United States District Court for the Western District of Arkansas as the Trustee in Bankruptcy of the Co-Op ("Trustee") and as representative of a class of the Co-Op's members and note holders. Defendants included officers and directors of the Co-Op; the Co-Op's legal counsel; and the Co-Op's auditors, including Arthur Young. The complaint alleged, *inter alia*, that Arthur Young had violated state and federal securities laws, as well as RICO.[9] After certain note holders intervened to seek representation independent of the Trustee, the district court certified a class of note holders ("Class").

The Trustee and the Class moved for summary judgment against the Co-Op's officers and directors, contending that the demand notes were securities and that the post-1979 failure to register the notes or obtain an exemption from registration violated the State Act. Arthur Young filed two briefs amicus curiae arguing that the demand notes were not securities under the state or federal securities laws.

The district court, after reviewing both state and federal precedent, held that the demand notes were securities under the State Act:

> [A] broad scale offering of unsecured debt instruments to a passive public constitutes an investment transaction, rather than a commercial loan.

---

[9] Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-68.

(Pet. A 40 (635 F. Supp at 856).) The court expressly rejected Arthur Young's argument that notes payable on demand could not be securities:

> The problem with a mechanical test such as [Arthur Young] would have us apply is that it elevates form over substance; furthermore, it allows the issuer, in this case the Co-Op, to choose a form – *i.e.*, demand notes – which evades regulation, while allowing it to substantially practice the very evil which blue sky laws were designed to deter: the broadscale, public solicitation of large amounts of unsecured capital for deployment in a speculative venture.

(Pet. A 74-75 (635 F. Supp. at 863-64); *see also* Pet. A 60-61 (635 F. Supp. at 860-61).)[10]

In a subsequent ruling, the district court concluded that the notes were securities under federal law as well. (Pet. A 30.) As the district court previously had recognized, "No federal court has ever suggested that a broad-scale public offering of notes is a transaction outside the

---

[10] In its post-trial opinion, the district court adopted the findings of fact set forth in 633 F. Supp. 954 and 635 F. Supp. 851 (Pet. A 32-81). Thus, the district court considered all the relevant evidence in deciding before trial that the notes were securities:

> Rather than recite anew the complex facts adduced in the testimony, we would refer the reader to our discussions in our opinions covering the motions to dismiss and the motions for summary judgment, which we believe represent fairly complete recitals of the evidence (certainly there were few, if any, "surprises" at trial, the witnesses having been thoroughly deposed in marathon sessions extending from January through August, 1986).

(CAJA 17.)

scope of the federal securities acts." (Pet. A 64 (635 F. Supp. at 861).)

The Class tried to a jury its securities claims against Arthur Young. The Class emphasized, among other things, Arthur Young's assignment of an improper value to the gasohol plant, as well as its false and misleading representations concerning the Co-Op's net worth and solvency. The Class presented an audit partner with Touche Ross as its auditing and accounting expert. He testified that Arthur Young violated 6 of the 10 Generally Accepted Auditing Standards (GAAS), that Arthur Young had improperly assigned a value of $4.5 million to the gasohol plant, and that the Co-Op would have shown a negative net worth had Arthur Young done its job properly. (Trans. XIV:157, 182, 186-88.) Arthur Young did not present on its own behalf any auditing or accounting expert witness.

After a five-week trial, the jury found Arthur Young liable under both the State Act and the Securities and Exchange Act of 1934 ("1934 Act"). It awarded the Class a rescission verdict of over $6.1 million.[11] Arthur Young made extensive post-trial motions seeking to overturn the verdict. Those motions were denied by the district court, which held:

> [T]he jury found on substantial evidence that Arthur Young originated the fraud, as we may say it was rather obvious that Arthur Young 'struggled hard' to make the Co-Op appear solvent against all available data and any reasonable characterization of it.

(CAJA 63.) After determining the prejudgment interest due and giving Arthur Young a credit of approximately $5.7 million for settlements with other defendants, the Court entered judgment for the Class and against Arthur Young in the total amount of $2,451,513.17. The judgment bears 6.3 percent annual interest from April 27, 1987 until paid. (JA 31-32.)

[11] During the period between Arthur Young's presentation of its first financial statements and the bankruptcy, Class members purchased over $6.1 million in new demand notes. (*See* JA 27-29.)

Proceedings In The Court Of Appeals

Arthur Young appealed.[12] The Eighth Circuit concluded that the notes were not securities under the State Act or the 1934 Act and then reversed the district court's order denying Arthur Young's motion for judgment notwithstanding the verdict on the state and federal securities claims.

In its opinion, the court first identified the test it believed to be applicable: "For the demand notes at issue to be considered securities under the Federal Act, they must satisfy the elements of the test developed in *SEC v. W.J. Howey Co.*," 328 U.S. 293 (1946). (Pet. A. 19-20 (reported at 856 F.2d 52, 54).) The court, however, attempted first to apply to notes the test for stock set forth by this Court in *Landreth Timber Co. v. Landreth*, 471

[12] The Class cross-appealed from (1) the district court's credit of settlement proceeds received from other defendants toward the amount of the judgment against Arthur Young and (2) the district court's entry of summary judgment in favor of Arthur Young on the Class' RICO claim.

U.S. 681 (1985). The Eighth Circuit determined that the Co-Op notes failed the *Landreth* test because, although they possess the name of an enumerated instrument, they lack the characteristics of a security. According to the Eighth Circuit, "[t]he demand nature of the notes is very uncharacteristic of a security." (Pet. A 20 (856 F.2d at 54).)

The court of appeals then returned to *Howey* and held that the Co-Op's demand notes failed the *Howey* test for two reasons. First, the court concluded that the note holders actually had made short-term commercial loans to the Co-Op and that the notes therefore were not "investments." Second, the court concluded that to be a security, a note must provide a reasonable expectation of profits and that payments of interest were not "profits." (Pet. A 21-23 (856 F.2d at 54-55).) Thus, according to the Eighth Circuit, the notes were not securities under the 1934 Act.[13] The Eighth Circuit also decided that the test for determining the scope of the term "security" under the State Act is "essentially the same" as the *Howey* test, and that therefore the Co-Op notes were not securities

[13] The Eighth Circuit upheld the dismissal of the Class' RICO claim, holding that "our disposition of the securities claims means that no predicate acts exist which could form the basis for RICO liability." (Pet. A 27-28 (856 F.2d at 55) (citation omitted).) If the Court reverses the judgment of the Eighth Circuit, the Eighth Circuit on remand will have to reconsider the RICO issue. The Eighth Circuit then will have the benefit of the Court's recent guidance on the "pattern" requirement. *H.J. Inc. v. Northwestern Bell Tel. Co.*, 109 S. Ct. 2893 (1989) (reversing judgment of Eighth Circuit).

under the State Act, either. (Pet. A 23-25 (856 F.2d at 55).)[14]

The Class petitioned the Eighth Circuit for rehearing and for rehearing en banc. The SEC and the Department filed briefs as amici curiae supporting the Class' petition. The court of appeals denied the petition by a six to four vote, with the minority filing a dissenting opinion. (Pet. A 1-7 (reported at 856 F.2d 55, 55-56).) On June 12, 1989, this Court granted the Class' petition for a writ of certiorari. (JA 33.)

SUMMARY OF ARGUMENT

This case involves the status of the Co-Op's notes under the federal securities laws. Under any analysis consistent with the federal acts, the Co-Op notes are securities. The notes are uninsured and uncollateralized demand notes offered to the public, described by the issuer as "investments," and sold to numerous passive investors. If these notes are not securities, then federal and state securities regulators will be powerless in the future to protect other investors from similar fraudulent offerings.

The Eighth Circuit erroneously concluded that the notes were not securities within the scope of the federal acts by improperly applying the tests for "stock" and for "investment contracts." The Eighth Circuit's approach

[14] While the Class strongly disagrees with this holding, reversal of the Eighth Circuit's decision on the federal securities claims will reverse the holding as to the State Act as well.

conflicts with the decisions of other courts of appeals, which have developed tests designed specifically for notes.

The Class asks this Court to resolve the conflict among the circuits and specify the proper test for determining whether a note is a security. The Class urges the adoption of the Second Circuit's "family resemblance" test or, alternatively, the majority "investment vs. commercial" test. Under these note tests, the Co-Op notes are securities. The demand feature of the Co-Op notes does not change this result.

ARGUMENT

I. INTRODUCTION

The Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act," collectively "Acts") both define the term "security" to include more than twenty varieties of financial instruments, including "any note."[15] The Acts do not further define notes or any of the other enumerated instruments.

[15] 15 U.S.C. § 77b(1) (section 2(1) of the 1933 Act); 15 U.S.C. § 78c(a)(10) (section 3(a)(10) of the 1934 Act, *reprinted supra* pages 1-2.).

This Court has stated that the Acts' definitions of "security" are "virtually identical and will be treated as such in our decisions dealing with the scope of the term." *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.1 (1985); *accord Marine Bank v. Weaver*, 455 U.S. 551, 555 n.3 (1982); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975); *see also* S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934) (definitions "substantially the same").

The legislative history of the Acts demonstrates that Congress defined "the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security." *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 847-48 (1975) (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 11 (1933)). Thus, "[t]he task has fallen to the Securities and Exchange Commission . . . and ultimately to the federal courts to decide which of the myriad financial transactions in our society come within the coverage of these statutes." *Forman*, 421 U.S. at 848.

There is no universal test for determining whether an instrument is a security.[16] Here, the Class asks the Court to address an issue it expressly reserved in 1985: the scope of the Acts' coverage of *notes*.[17] The courts of appeals, in the many cases addressing this issue, agree that not all notes are securities. The various courts of appeals have not agreed on the appropriate method for determining which notes are securities; instead, they have developed four distinct tests.

[16] "Each type of financial instrument listed in the statutory definition of security is susceptible to a separate analysis, employing separate analytical concepts. There is no universal or generic test of the term." 2 L. Loss & J. Seligman, *Securities Regulation* 871 & n.5 (1989). For example, this Court recently held that the test for determining whether an "investment contract" is a "security" is not applicable to traditional stock. *See infra* pages 19-20.

[17] *See infra* page 17.

The Class urges this Court to settle the conflict among the circuits and adopt a single test for notes. Note offerings often extend beyond the boundaries of a state or circuit. The Co-Op notes, for example, were sold in both the Eighth and Tenth Circuits (which now apply vastly different tests).[18] Whether a note holder has purchased a "security" should not depend upon the circuit in which he or she resides.

From among the four tests, this Court certainly should reject the Eighth Circuit's approach. The Eighth Circuit's use of the tests for "stock" and for "investment contracts" is contrary to the precedent of this Court and other federal courts, and neither of those tests is appropriate in a note context. Rather, the Class urges the Court to adopt the Second Circuit's "family resemblance" test or, alternatively, the majority "investment vs. commercial" test. Both of these tests were designed specifically for determining whether a note is a security. Application of these note tests amply demonstrates that the Co-Op notes are securities. Furthermore, there is no basis in the language of the statute for excluding notes payable on demand from the coverage of the Acts.

In the event that this Court does not adopt a particular test, the Court should hold that uninsured and uncollateralized demand notes offered to the public, described by the issuer as "investments," and sold to numerous

---

[18] *Compare* the Eighth Circuit's decision in this case *with Holloway v. Peat, Marwick, Mitchell & Co.*, Nos. 87-1486, 87-1490, slip op. at 5-10 & n.9 (10th Cir. July 11, 1989) (available on Westlaw) (expressly rejecting the Eighth Circuit's analysis in this case).

passive investors are securities under the federal securities laws. The judgment of the Eighth Circuit therefore should be reversed.

II. THIS COURT SHOULD RESOLVE THE CONFLICT AMONG THE COURTS OF APPEALS AND SPECIFY THE TEST FOR DETERMINING WHETHER A NOTE IS A "SECURITY."

A. The Eighth Circuit Erroneously Applied The *Landreth* Test For Stock To An Issuance Of Notes.

In *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), the instrument at issue was "traditional stock." *Id.* at 690. In determining whether the stock was a security under the Acts, the Court first held that the *Howey* test for "investment contracts" was inapplicable to stock. *Landreth*, 471 U.S. at 689-92 & nn.4-5. The Court instead announced an entirely different test for stock: "Instruments that bear both the name and all of the usual characteristics of stock" are covered by the Acts, and there is no need to examine the economic substance of stock transactions. *Id.* at 690, 693. That is, there is no need to look at the context in which the stock was issued.

The Court limited this holding to "stock" and "expressly [left] until another day the question whether 'notes' or 'bonds' or some other category of instrument listed in the definition might be shown 'by proving [only] the document itself.'" *Id.* at 694 (quoting *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943)). Now that the day has arrived, the Class does not contend that the *Landreth* test should be applied to notes. For the reasons

this Court identified, stock is "in a category by itself." *Landreth*, 421 U.S. at 693-94. Unlike stock, notes have "widely varying characteristics," *see id.* at 694, and they sometimes are issued in the context of certain commercial or consumer transactions that are not investments. *See infra* pages 23-30.

The Eighth Circuit's version of the *Landreth* test apparently looks only to the terms and features stated on the face of a note. The Eighth Circuit applied this test to the Co-Op notes and determined, without reference to the context of the transactions, that the demand feature of the notes was "uncharacteristic of a security." There is no statutory basis for this conclusion, *see infra* pages 33-36, and disregarding the context of other note transactions would produce similarly anomalous results. For example, an uninsured and unsecured note with a five-year term presumably would satisfy the Eighth Circuit's version of the *Landreth* test, even if the note was issued in a consumer financing transaction. In any other circuit, the context of that note would exclude it from the coverage of the Acts. *See infra* pages 22-33.

Thus, the *Landreth* test has no application to notes, and notes must be analyzed in the context of their issuance. The *Landreth* Court foreshadowed this result in dictum:

> '[N]ote' may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context.

471 U.S. at 694 (citing *Securities Industry Ass'n v. Board of Governors of Federal Reserve System*, 468 U.S. 137, 149-53 (1984)).

The language of the Acts justifies this inquiry into the context of a note transaction. Each of the Acts' definitions, including the ones for "security," is preceded by the phrase "unless the context otherwise requires." *See supra* pages 1-2 (reprinting § 3(a)(10) of the 1934 Act); *see* 15 U.S.C. § 77b (1933 Act). Most courts and commentators have interpreted "context" to refer to the economic reality of the transaction underlying the issuance of the instruments.[19]

B. In Examining The Context In Which The Notes Were Issued, The Eighth Circuit Mistakenly Applied The *Howey* Test.

In *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), this Court held that an "investment contract" is a "security" only if the transaction in which the instrument was

---

[19] *Holloway*, slip op. at 16-17 n.5; *see* 2 L. Loss & J. Seligman, *Securities Regulation* 873-74 (1989) (context of transaction especially important in note cases). Of course, each of the note tests described below necessarily requires an inquiry into the circumstances of the transaction.

Two courts, however, have held that "context" refers only to the usage of the defined words within the text of the Acts. *American Bankers Ass'n v. SEC*, 804 F.2d 739, 753-54 (D.C. Cir. 1986); *Ruefenacht v. O'Halloran*, 737 F.2d 320, 330-32 (3d Cir. 1984), *aff'd sub nom. Gould v. Ruefenacht*, 471 U.S. 701 (1985). This Court has implicitly rejected this restrictive view in considering the context of the transactions in *Marine Bank v. Weaver*, 455 U.S. 551, 560 & n.11 (1982).

issued "involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Id.* at 298-301. The *Howey* test also applies to an instrument that might fall within the term "an instrument commonly known as a 'security,' " the catch-all phrase at the end of the definitions' list of security instruments. *See Landreth*, 471 U.S. at 691 n.5.

Both "investment contracts" and "an instrument commonly known as a 'security' " are "general categories" of securities, *id.*, and the precedents of this Court that analyze instruments under these general categories "involved unusual instruments that did not fit squarely within one of the enumerated specific kinds of securities listed in the definition." *Id.* at 689 n.4 & 690.

The *Landreth* Court therefore stated that the *Howey* test should apply to the general categories of instruments, but not to the specific kinds of instruments, enumerated in the Acts:

> [T]he *Howey* economic reality test was designed to determine whether a particular instrument is an 'investment contract,' not whether it fits within *any* of the examples listed in the statutory definition of 'security.' . . . Moreover, applying the *Howey* test to traditional stock and all other types of instruments listed in the statutory definition would make the Acts' enumeration of many types of instruments superfluous.

Landreth, 471 U.S. at 691-92 (citations omitted; emphasis in original). The *Landreth* Court held the *Howey* test inapplicable to the specific instrument "stock," *Landreth*, 471 U.S. at 691-92, and lower courts have similarly held *Howey* inapplicable to notes. *Holloway v. Peat, Marwick, Mitchell & Co.*, Nos. 87-1486, 87-1490, slip. op. at 9 (10th

Cir. July 11, 1989) (available on Westlaw); *Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484, 491 (7th Cir. 1984); *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1136 (2d Cir. 1976); *Briggs v. Sterner*, 529 F. Supp. 1155, 1167-69 (S.D. Iowa 1981). Only the Eighth Circuit (in this case) and the D.C. Circuit have applied the *Howey* test to notes. 856 F.2d at 54-55; *Baurer v. Planning Group, Inc.*, 669 F.2d 770, 777-79 (D.C. Cir. 1981); *Johnson v. Computer Technology Services, Inc.*, 670 F. Supp. 1036, 1038 (D.D.C. 1987).[20]

The Eighth Circuit's application of the *Howey* test to the Co-Op notes demonstrates why the test is inappropriate in a note context. The court of appeals held that the Co-Op notes failed two elements of the *Howey* test: the demand notes were not "investments," and the interest paid on the notes was not "profits." It is the "profits" element of the *Howey* test that cannot apply in a note context.[21] This Court has interpreted *Howey*'s "profits"

---

[20] Although the Seventh Circuit recently considered whether a fixed rate of interest could be "profits" under the *Howey* test, that case turned on whether a bank's financing of a program which sold limited partnership interests was an "investment contract." To the extent an instrument was involved, it was not a note. *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 941-42 (7th Cir. 1989).

[21] The "investment" element of the *Howey* test is not unreasonable, given that the overriding purpose of the Acts is to protect investors. *See infra* pages 24-25 and note 27. The Eighth Circuit, however, found that this element was not met only by ignoring the vast scale of the Co-Op's public offering and arbitrarily removing notes payable on demand from the scope of the Acts. *See infra* pages 28-29.

element to include either "capital appreciation" or "participation in earnings." *Forman*, 421 U.S. at 852. These definitions of "profits" seem to exclude the interest that notes always pay, especially if the interest rate is fixed or tied to an established market rate. *E.g.*, *Holloway*, slip op. at 9; *Hunssinger*, 745 F.2d at 490-91.

In this case, the Co-Op notes paid a variable rate, which the Co-Op's managers set every month.[22] If the Co-Op notes did not yield "profits," then twenty-year, fixed-rate corporate bonds offered to the public must also fail that element of the *Howey* test. *See id.* In light of these sound reasons for not applying *Howey* to notes, most courts of appeals have used other tests that are designed especially for notes.

C. Among The Note Tests Developed By The Courts Of Appeals, The Class Favors The Second Circuit's "Family Resemblance" Test.

The Class urges the Court to adopt the Second Circuit's note test,[23] which most closely follows the statutory language and which provides the most guidance to the district courts. The Second Circuit's approach is known as the "family resemblance" test or the "literal"[24] test.

---

[22] *See supra* page 4.

[23] *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 936-39 (2d Cir.), *cert. denied*, 469 U.S. 844 (1984); *Exchange Nat'l Bank*, 544 F.2d at 1131-38; *see SEC v. American Board of Trade*, 751 F.2d 529, 538-40 (2d Cir. 1984).

[24] Judge Friendly, writing for the Second Circuit, found the "literal" characterization "pejorative" and stated that the

(Continued on following page)

Because the Acts define "security" to include "any note," the Second Circuit presumes that any given note is a security.[25] Then, the statutory language preceding the definitions directs that this presumption will govern unless "the context otherwise *requires*." *Exchange Nat'l Bank*, 544 F.2d at 1137-38 (citing preface to definitions in Acts) (emphasis supplied by court). The context of a note transaction[26] will "otherwise require" only if a note "bear[s] a strong family resemblance" to certain categories of notes that are outside the scope of the securities laws. *Id.* at 1138. In *Exchange Nat'l Bank*, the court listed the following categories of "non-securities":

(Continued from previous page)

court did not regard the decision setting forth its test "as taking a 'literalist' or even a 'neo-literalist' approach. Its position was and is that the words of the statute are not to be disregarded, as some other approaches have done . . . ." *Chemical Bank*, 726 F.2d at 938.

The approaches that the Second Circuit declined to follow were the majority "investment vs. commercial" test and the Sixth and Ninth Circuit's "risk capital" test, both of which are discussed below.

[25] When announced in *Exchange Nat'l Bank*, this test applied to notes with maturities in excess of nine months. 544 F.2d at 1137-38. The court of appeals took no position with respect to notes with maturities of nine months or less. *Id.* at 1138 n.19. In *American Board of Trade*, the Second Circuit expressly recognized that the exemptions for short-term instruments in the Acts apply only to commercial paper and not to publicly-offered notes. *See infra* pages 33-36 (especially quotation from *American Board of Trade*). The reasoning of the court necessarily extended the test (and its presumption) to all notes, regardless of their maturity. 751 F.2d at 538-40.

[26] *See supra* page 19 and note 19.

> the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).

Id. at 1138.

In a subsequent decision, the Second Circuit recognized that this list was "not graven in stone," and the court added to the list "notes evidencing loans by commercial banks for current operations," regardless of their maturity. *Chemical Bank*, 726 F.2d at 939. Thus, courts applying the "family resemblance" test in the future might identify other categories of notes that clearly fall outside the Acts' coverage.

Applying the "family resemblance" test here, the Co-Op notes are presumptively securities. The next step is to determine whether the Co-Op notes "bear a strong family resemblance" to any of the categories of notes, as set forth above, that clearly are not securities. The Co-Op notes were offered to the general public as "investments" and sold in small denominations. Over 1600 persons purchased notes, in a total amount of over $10 million. The Co-Op notes were neither insured nor collateralized, were payable on demand, and bore a variable rate of interest. *See supra* pages 3-4.

The Co-Op notes do not strongly or even remotely resemble any of the categories of non-securities set forth above. Given the Acts' overriding purpose of protecting

investors,[27] notes like the Co-Op's could never become an addition to the Second Circuit's list of non-securities. Should the Court adopt the "family resemblance" test, the Co-Op notes must be securities.

D. Alternatively, The Class Requests Adoption Of The Majority "Investment Vs. Commercial" Test.

The test in use by most courts of appeals is the "investment vs. commercial" test (or the "investment/commercial dichotomy" test). In the event that this Court does not adopt the "family resemblance" test, the Class requests the adoption of the "investment vs. commercial" test.

To determine whether a note is a security, the First, Third, Fifth, Seventh, and Tenth Circuits use the "investment vs. commercial" test to examine the context of the transaction[28] in which the note is issued.[29] Notes that

---

[27] The 1933 Act and 1934 Act were "intended to encourage 'honest dealing in securities and thereby bring back public confidence' in the investment markets and to eliminate the 'unethical and unsafe practices of bank and corporate officers.' " *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 237 (2d Cir. 1985) (quoting Letter from President Franklin D. Roosevelt to Congress (Mar. 29, 1933), *reprinted* in 77 Cong. Rec. 937 (1933)); *see also Exchange Nat'l Bank*, 544 F.2d at 1133 (citing President's letter and Senate Committee report).

[28] *See supra* page 19 and note 19.

[29] *E.g., Holloway*, slip op. at 6; *Futura Dev. Corp. v. Centex Corp.*, 761 F.2d 33, 40-41 (1st Cir.), *cert. denied*, 474 U.S. 850 (1985); *Hunssinger*, 745 F.2d at 489; *McClure v. First Nat'l Bank*,

(Continued on following page)

evidence investment transactions fall within the coverage of the Acts, while notes issued in a commercial (or consumer) context do not. Purchasers of investment instruments are dependent on the managerial efforts and financial disclosures of others, and therefore should enjoy the protections of the federal securities laws. *E.g., Futura Dev. Corp.*, 761 F.2d at 40-41.

Courts applying the "investment vs. commercial" test have identified a number of factors that are relevant in examining the context of a note transaction. These factors include: (1) the scope and duration of the offering; (2) the number of notes issued, the number of purchasers, and the amounts involved; (3) how the note is characterized in the offerings, in financial statements, and in the business community; (4) whether the seller of the note uses the proceeds for particular goods or services (commercial) or for the general financing of its enterprise (investment); (5) the extent to which purchasers rely on the efforts of others; (6) whether the notes are insured or collateralized; and (7) the length of the note's term.[30]

(Continued from previous page)

497 F.2d 490, 494-95 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Lino v. City Investing Co.*, 487 F.2d 689, 693-95 (3d Cir. 1973).

[30] *See, e.g., C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc.*, 508 F.2d 1354, 1361 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975) (citing Comment, *Commercial Notes and Definition of "Security" Under Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 Neb. L. Rev. 478, 510-24 (1973)); *Zabriskie v. Lewis*, 507 F.2d 546, 551 & n.9 (10th Cir. 1974); *see also* Jacobs, *The Meaning of "Security" Under Rule 10b-5*, 29 N.Y.L. Sch. L. Rev. 211 (1984).

While these criteria are "helpful," the characterization of "investment" or "commercial" is made on a case-by-case basis.[31]

1. The Co-Op Notes Evidence Investments And Therefore Are Securities.

Here, these factors demonstrate the investment nature of the Co-Op notes. For over 25 years, the Co-Op offered its notes to its 23,000 members and to non-members as well. At the time of the Co-Op's bankruptcy, more than 1600 persons held notes in a total amount of over $10 million. The notes were issued in any denomination requested, with a minimum of $100. The Co-Op's advertisements refer to "investments" made through the Co-Op "Investment Program." The Co-Op's draft Offering Statement similarly characterizes the notes as "investments" and the note holders as "investors." *See supra* pages 3-4. Until this case reached the Eighth Circuit, no one ever described the transactions underlying the Co-Op notes as "loans."

In addition, the Co-Op used the proceeds of the notes to finance its day-to-day operations, rather than for the purchase of specific goods or services. The note holders were passive investors who relied on the efforts and managerial skills of the Co-Op's management. The notes were neither insured nor collateralized, and they were payable on demand. *See supra* pages 3-4.

---

[31] *C.N.S. Enterprises*, 508 F.2d at 1362; *accord Hunssinger*, 745 F.2d at 488; *McClure*, 497 F.2d at 493 n.2.

Except for the absence of a long term of maturity, the Co-Op notes possess every indicia of a note evidencing an "investment." "Not all factors . . . must point in the same direction in order for an instrument to be an investment." *Holloway*, slip op. at 6; *accord Zabriskie*, 507 F.2d at 551-52. Courts applying the "commercial vs. investment" test consistently have held that notes offered to the general public in small denominations as investments are securities. *See, e.g., Holloway*, slip op. at 17 n.8; *Hunssinger*, 745 F.2d at 492-93; *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1079-80 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972); *see also McClure*, 497 F.2d at 493-94 (collecting cases as of 1974). "The solicitation of members of the general public seeking a passive return from their capital and the sale to them of units of a larger offering are the hallmarks of an investment transaction." *Hunssinger*, 745 F.2d at 492. Under the majority test, therefore, the Co-Op notes certainly evidence "investments" and not "commercial" loans.[32]

2. Notes Payable On Demand May, Under Appropriate Circumstances, Be Securities.

The Eighth Circuit, in applying the *Howey* test, made no effort to examine the many factors relevant to the

---

[32] The Eighth Circuit erroneously held that the interest-bearing nature of the Co-Op notes excluded the notes from the coverage of the Acts. "A fixed rate of interest is simply a characteristic of the general category 'notes.' A note that bears a fixed rate of interest is just as likely to be an investment as it is likely to be evidence of a commercial loan." *Hunssinger*, 745 F.2d at 489. In this case, the rate of interest paid on the Co-Op notes was not even fixed; Co-Op management adjusted the rate monthly in accordance with its analysis of market conditions. *See supra* page 4.

"investment vs. commercial" test. The court simply ignored the wide-scale public offering of the Co-Op "Investment Program," and focused on the demand feature of the Co-Op notes to determine whether the notes were investment instruments. The Eighth Circuit's approach was wrong. "The maturity of a note is . . . not dispositive. Instead, the commercial or investment character of the underlying transaction determines whether an instrument is a security." *Holloway*, slip op. at 5; *accord SEC v. Continental Commodities Corp.*, 497 F.2d 516, 525 (5th Cir. 1974) ("[I]t is the character of the note, not its maturity date, which determines coverage" under the federal securities laws); *C.N.S. Enterprises*, 508 F.2d at 1360-61 & n.13; *McClure*, 497 F.2d at 494-95.[33]

Thus, notes that are issued in an investment context will be securities even if the notes are payable on demand. *Holloway*, slip op. at 7-10; *Zeller v. Bogue Electric Mfg. Corp.*, 476 F.2d 795, 799-800 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *United States v. Attaway*, 211 F. Supp. 682, 685 (W.D. La. 1962); *Briggs*, 529 F. Supp. at 1163, 1168-69; *Fund of Funds, Ltd. v. Vesco*, [1976-1977] Fed. Sec. L. Rep. (CCH) ¶ 95,644, at 90,192-95 & n.20 (S.D.N.Y. July 21, 1976).

In *Holloway*, the notes at issue were "passbook savings certificates" and "thrift certificates" offered by a finance company and a trust company to the general public. Over 10,000 passive investors purchased the notes

---

[33] The Acts, except in the context of commercial paper, do not distinguish among notes based on their maturity. *See infra* pages 33-36.

in various denominations.[34] The notes paid a fixed rate of interest, were not collateralized, and were payable either after a specified term or upon demand.[35] The issuers used the note proceeds for general financing, described contributions by purchasers as "investments," and characterized the notes in prospectuses filed with the Oklahoma Securities Commission as "securities." Slip op. at 6-8.

In determining whether these notes are securities, the Tenth Circuit expressly rejected the Eighth Court's application of the *Howey* test to notes. *Holloway*, slip op. at 18 n.9. Instead, the Tenth Circuit applied the "investment vs. commercial" test and found that the notes evidenced investments and therefore are "securities." *Id.* at 6-10. The Co-Op demand notes are indistinguishable from the demand notes in *Holloway*, and the "investment vs. commercial" test certainly would hold the Co-Op notes to be investment securities as well.[36]

---

[34] While *Holloway* also involved a promissory note that a bank holding company issued, the Tenth Circuit remanded for further findings as to that particular note. Slip op. at 15.

[35] There were some restrictions that the issuers could place on a demand for redemption. The issuers reserved the right to require thirty days' notice or to limit the amount of redemption in any month to one-half of the previous month's cash flow. *Holloway*, slip op. at 16 n.3. These restrictions did not affect the analysis of the court, which found that the notes possessed a "demand character." *Id.* at 9.

[36] The Class favors the Second Circuit approach because notes initially are presumed securities, and because the Second Circuit's enumerations of "commercial" transactions provides more guidance to district courts. Nevertheless, these two tests are unlikely to reach inconsistent results, and the Class alternatively favors adoption of the "investment vs. commercial" test.

E. The "Risk Capital" Test Is A Reformulation Of The *Howey* Test And Thus Should Not Apply To Notes.

The Sixth and Ninth Circuits use the "risk capital" test to determine whether notes are securities.[37] This test turns on whether the holder of the note invested risk capital in a venture that is subject to the managerial efforts of others.[38] The "risk capital" test, while designed specifically for notes, "is merely an elaboration of *Howey*." L. Loss, *Fundamentals of Securities Regulation* 168 n.7 (1988).

Most courts and commentators have found the risk capital test, like the *Howey* test, to be inappropriate and unworkable in the context of notes. *See, e.g., Futura Dev. Corp.*, 761 F.2d at 41 ("Many investments . . . such as those involving markets in commercial paper are specifically designed to be low risk, yet such transactions were

---

[37] *E.g., Underhill v. Royal*, 769 F.2d 1426, 1431 (9th Cir. 1985); *American Bank & Trust v. Wallace*, 702 F.2d 93, 96 (6th Cir. 1983); *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1257-58 (9th Cir. 1976).

[38] Courts applying the "risk capital" test have identified the following relevant factors: (1) time, (2) collateralization, (3) form of the obligation, (4) circumstances of issuance, (5) relationship between the amount borrowed and the size of the borrower's business, and (6) the contemplated use of the funds. *Underhill*, 769 F.2d at 1431. None of these factors is dispositive, and the list is not exhaustive. *Id.* Like the "investment vs. commercial" test, the "risk capital" test employs a multi-factor analysis that is less determinate than the "family resemblance" test.

clearly intended by Congress to fall within the Acts."); *Exchange Nat'l Bank*, 544 F.2d at 1136 ("we do not see much force in the test"); Jacobs, *supra*, at 377 ("A strict application of the risk capital test leads to the following anomolous [sic] result: A public debt offering by a blue chip corporation is not a security, while a six-month, $5,000 'character' bank loan to enable an old customer to enter a new business is a security." (footnote omitted)).

The "risk capital" test is further flawed by an undue focus on the maturity of the note:

> The most important factor is time. . . . A demand or short-term note is almost *ipso facto* not a security unless payment is dependent upon the success of a risky enterprise, or the parties contemplate indefinite extension of the note or perhaps conversion to stock.

Great Western Bank, 532 F.2d at 1257-58 (citations omitted). While this test places notes payable on demand in the same category as notes with short maturities, there is no reason to presumptively exclude either type of note from the coverage of the Acts. This case is the best illustration of the strange results this negative presumption can produce. The Eighth Circuit relied on the quoted language from *Great Western Bank* in holding that notes offered to the public, described by the issuers as "investments," sold to numerous passive investors, and used by the seller to finance its operations (including a risky gasohol plant) are not securities. *See also* 2 L. Loss & J. Seligman, *supra*, at 888 & n.60 (criticizing test's use of time as "most important factor").

The Class therefore asks this Court to reject the "risk capital" test and hold that the Eighth Circuit's reliance on *Great Western Bank* was mistaken.[39]

III. THE ACTS' EXEMPTIONS FOR SHORT-TERM NOTES APPLY ONLY TO COMMERCIAL PAPER, AND NOT TO PUBLICLY-OFFERED INSTRUMENTS LIKE THE CO-OP NOTES.

The definition of "security" in section 3(a)(10) of the 1934 Act excludes instruments commonly known as "commercial paper":

> The term "security" . . . shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10). A virtually identical exemption from registration is set forth in section 3(a)(3) of the 1933 Act. *See* 15 U.S.C. § 77c(a)(3).[40] In another context, this

---

[39] In the event this Court does adopt the "risk capital" test, however, the Class believes that the Co-Op notes are securities under this test as well. The Co-Op was a risky enterprise, as shown by the speculative nature of the gasohol plant and the eventual collapse of the Co-Op. The note holders were staking their funds on the financial success of the enterprise, without the protection of collateral or insurance.

[40] By exempting commercial paper from the definition of "security," the 1934 Act exempts commercial paper from all of the 1934 Act's provisions. The 1933 Act, however, contains a separate exemption (not in the definition), and thus commercial paper is exempted from the registration but not the anti-

(Continued on following page)

Court recognized that these exemptions are limited to commercial paper: "[T]he definition of the term 'security' [in the 1933 Act and 1934 Act, among others] includes commercial paper, and each statute contains explicit exceptions where Congress meant for the provisions of an Act not to apply to commercial paper." *Securities Industry Ass'n v. Board of Governors of Federal Reserve System*, 468 U.S. 137, 150-51 & n.7 (1984) (citing exemption provisions in Acts).

The legislative history of the 1933 Act supports that conclusion. The House Report on the 1933 Act stated that the section 3(a)(3) exemption applied to "short-term paper of the type available for discount at a Federal Reserve bank and of a type which rarely is bought by private investors." H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933). The Senate Report further demonstrates that Congress never intended to exclude publicly-offered, short-term investment notes (such as the Co-Op notes) from the coverage of the 1933 Act:

> Notes, drafts, bills of exchange, and bankers' acceptances which are commercial paper and arise out of current commercial, agricultural, or industrial transactions, and which are not intended to be marketed to the public, are exempted. . . . It is not intended under the bill to require the registration of short-term commercial paper which, as is the usual practice, is made to mature in a few months and originally is not advertised for sale to the general public.

S. Rep. No. 47, 73d Cong., 1st Sess. 3-4 (1933).

(Continued from previous page)

fraud provisions of the 1933 Act. *Zeller*, 476 F.2d at 799; *see Securities Industry Ass'n v. Board of Governors of Federal Reserve System*, 468 U.S. 137, 151 (1984).

The SEC followed these statements of congressional intent in a 1961 interpretive release:

> The legislative history of the [1933] Act makes clear that section 3(a)(3) applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks.

Securities Act Release No. 4412 (Sept. 20, 1961), 1 Fed. Sec. L. Rep. (CCH) ¶ 2045 (Apr. 24, 1987); *see* 3 L. Loss & J. Seligman, *supra*, at 1187-90.

The legislative history of the 1933 Act and the SEC's interpretive release apply with equal force to the exemption for commercial paper in section 3(a)(10) of the 1934 Act. *American Board of Trade*, 751 F.2d at 539; *Sanders*, 463 F.2d at 1078-80; *Zeller*, 476 F.2d at 799-800. The intent of Congress in enacting these exemptions, and indeed the two Acts' overriding purpose of protecting investors, would be defeated by excluding publicly-offered investment notes from the scope of the Acts simply because they bear maturities of less than nine months or are payable on demand:

> It is inconceivable that Congress intended § 3(a)(3) to exempt from registration a periodic public offering of the issuer's own notes to small investors simply because their maturity was less than nine months. It is almost equally unlikely that Congress meant that an issuer soliciting broad public investment in notes issued for general corporate purposes should be able to avoid the anti-fraud provisions of the 1934 Act simply by arranging that they should have "a maturity at the time of issuance of not exceeding nine months."

American Board of Trade, 751 F.2d at 539-40 (footnote omitted); *accord Holloway*, slip op. at 9-10.

The Co-Op notes are not commercial paper. "[A] person who seeks to invest his money and receives a note in return for it has not purchased commerical paper in the usual sense. He has purchased a security investment." *Sanders*, 463 F.2d at 1080. Thus, there is no basis in the statutory language for excluding the Co-Op notes, or any other demand or short-term investment note, from the scope of the term "security" in the 1934 Act.

IV. IF THIS COURT DOES NOT ADOPT A UNIFORM TEST FOR NOTES, THEN THE COURT SHOULD HOLD THAT NOTES OFFERED TO THE PUBLIC AS "INVESTMENTS," SOLD TO MANY PASSIVE INVESTORS, AND PROTECTED BY NEITHER COLLATERAL NOR INSURANCE ARE SECURITIES.

"Despite the diversity of the [family resemblance, investment vs. commercial, and risk capital] approaches, they do contain a common core; that is, an issue of notes of whatever maturity sold to more than a few purchasers who are not in the business of loaning money will be deemed securities." Jacobs, *supra*, at 381-82 (footnote omitted). Had the Eighth Circuit recognized this common core, it never could have held that the Co-Op notes were outside the scope of the Acts. The Acts were designed primarily to protect investors, especially if they are not protected by any other regulatory scheme. *See Marine Bank v. Weaver*, 455 U.S. 551, 556-59 (1982). The Eighth Circuit's decision, if allowed to stand, would render the SEC and the state regulators powerless in at least seven

states to protect investors from fraudulent offerings of demand notes. Even without reference to any existing test, the Co-Op notes must be securities within the scope of the federal securities laws.

CONCLUSION

The decision of the United States Court of Appeals for the Eighth Circuit should be reversed, and this case should be remanded for further proceedings.

Dated: July 27, 1989

Respectfully submitted,

GARY M. ELDEN
JOHN R. MCCAMBRIDGE*
JAY R. HOFFMAN
GRIPPO & ELDEN
20 South Clark Street
Chicago, Illinois 60603
(312) 704-7700

ROBERT R. CLOAR
Court Plaza, Suite 102
51 South 6th Street
Fort Smith, Arkansas 72901
(501) 783-1186

Attorneys for Petitioners

*Counsel of Record

RESPONDENT'S

BRIEF

BEST AVAILABLE COPY

QUESTIONS PRESENTED

1. Whether demand notes are outside the definition of "security" in section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10), because the definition expressly excludes notes having a maturity of nine months or less.

2. Whether demand notes are outside the statutory definition of "security" because, under the framework established in prior decisions of this Court, they have none of the usual characteristics of a security.

TABLE OF CONTENTS

Page

STATEMENT OF THE CASE 1

THE DEMAND NOTE PROGRAM 1

THE ROLE OF ARTHUR YOUNG 2

THE CASE BELOW 3

SUMMARY OF ARGUMENT 6

ARGUMENT:

I. THE 1934 ACT, BY ITS TERMS, REQUIRES THAT THESE DEMAND NOTES BE HELD NOT TO BE SECURITIES 9

A. The Language of the 1934 Act Excludes Demand Notes from the Definition of "Security" 9

1. Demand Notes Fall Squarely within the Nine-Month Exclusion and That Result Is Not Affected by the "Context" Clause 10

2. The Court Should Enforce the Plain Language of the Nine-Month Exclusion 11

3. No Legislative History Supports the Treatment of Demand Notes as Securities 15

B. No Policy Considerations Militate Against Applying the 1934 Act As Written 19

Page

II. ALTERNATIVELY, THE COURT SHOULD APPLY TO NOTES THE APPROACH IT USED IN *LANDRETH* AND DETERMINE THAT THESE DEMAND NOTES ARE NOT SECURITIES.....23

A. The Three Court of Appeals Tests for Notes..... 24

1. Commercial/Investment.....24

2. Risk Capital 26

3. Family Resemblance 27

B. The *Landreth* Approach Applied to Notes.....29

1. Introduction 29

2. The *Landreth* Decision..... 30

3. The Extension of the *Landreth* Approach to Other Enumerated Securities.....31

4. *Landreth*, *Howey* and Notes.....33

5. The *Landreth* Approach Is Superior to the Family Resemblance Test.....37

C. The *Landreth* Approach Applied to the Demand Notes in This Case..... 39

Page

III. UNDER ANY OF THE COURT OF APPEALS TESTS, THE DEMAND NOTES ARE NOT SECURITIES.....41

A. Commercial/Investment..... 41

B. Risk Capital 42

C. Family Resemblance 43

CONCLUSION.....44

TABLE OF AUTHORITIES

Page

Cases

Adena Exploration, Inc. v. Sylvan, 860 F.2d 1242 (5th Cir. 1988) 32, 38

American Bank & Trust Co. v. Wallace, 702 F.2d 93 (6th Cir. 1983) 20, 24

American Bankers Ass'n v. SEC, 804 F.2d 739 (D.C. Cir. 1986) 38

Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986) 4

Barrett v. United States, 423 U.S. 212 (1976) 14

Basic Inc. v. Levinson, 485 U.S. 224 (1988) 12

Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974) 17, 20

Bethesda Hosp. Ass'n v. Bowen, 108 S. Ct. 1255 (1988) 16

Blanchard v. Bergeron, 109 S. Ct. 939 (1989) 14

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) 13

Bourjaily v. United States, 483 U.S. 171 (1987) 14

Broad v. Rockwell Int'l Corp., 614 F.2d 418 (5th Cir. 1980) 33-34

Page

Caminetti v. United States, 242 U.S. 470 (1917).....13

Chan v. Korean Air Lines, Ltd., 109 S. Ct. 1676 (1989).....13-14

Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).....16

Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930 (2d Cir. 1984), *reversing* 552 F. Supp. 439 (S.D.N.Y. 1982).....28

Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107 (2d Cir. 1967).....34

Chiarella v. United States, 445 U.S. 222 (1980).....4, 12

C.N.S. Enterprises, Inc. v. G.&G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).....24-25, 42

Commercial Discount Corp. v. Lincoln First Commercial Corp., 445 F. Supp. 1263 (S.D.N.Y. 1978).....28

Commissioner v. Asphalt Prod. Co., 482 U.S. 117 (1987).....13

Daily v. Morgan, 701 F.2d 496 (5th Cir. 1983).....30-31

Davis v. Michigan Dept. of Treasury, 109 S. Ct. 1500 (1989).....14

El Khadem v. Equity Sec. Corp., 494 F.2d 1224 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974).....36

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).....12-13

Page

Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976).....*passim*

Girouard v. United States, 328 U.S. 61 (1946).....14

Gould v. Ruefenacht, 471 U.S. 701 (1985).....13

Great Western Bank & Trust Co. v. Kotz, 532 F.2d 1252 (9th Cir. 1976).....24, 26, 43

H.J. Inc. v. Northwestern Bell Tel. Co., 109 S. Ct. 2893 (1989).....23

Holloway v. Peat, Marwick, Mitchell & Co., 879 F.2d 772 (10th Cir. 1989).....25-26

Hunssinger v. Rockford Business Credits, Inc., 745 F.2d 484 (7th Cir. 1984).....36

Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985).....*passim*

Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979).....34

Marine Bank v. Weaver, 455 U.S. 551 (1982).....12, 21, 29, 34

McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974).....11-12, 24, 35

McLaughlin v. Richland Shoe Co., 108 S. Ct. 1677 (1988).....14

McMahon v. O'Keefe, 213 Ark. 105, 209 S.W.2d 449 (Ark. 1948).....10

One-O-One Enterprises, Inc. v. Caruso, 848 F.2d 1283 (D.C. Cir. 1988) 32

Patterson v. McLean Credit Union, 109 S. Ct. 2363 (1989) 14

Pennsylvania v. Union Gas Co., 109 S. Ct. 2273 (1989) 14

Penturelli v. Spector, Cohen, Gadon & Rosen, 779 F.2d 160 (3d Cir. 1985) 31-32

Pinter v. Dahl, 108 S. Ct. 2063 (1988) 12, 21

Pittston Coal Group v. Sebben, 109 S. Ct. 414 (1988) 16

Redington v. Touche Ross & Co., 443 U.S. 904 (1979) 12

Rochelle v. Marine Midland Grace Trust Co., 535 F.2d 523 (9th Cir. 1976) 34

Ruefenacht v. O'Halloran, 737 F.2d 320 (3d Cir. 1984), *aff'd sub nom. Gould v. Ruefenacht*, 471 U.S. 701 (1985) 28

Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972) 11, 17

Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) 12, 13

SEC v. American Board of Trade, Inc., 751 F.2d 529 (2d Cir. 1984) 43

SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) 29, 30, 31

SEC v. First American Bank & Trust Co., 481 F.2d 673 (8th Cir. 1973) 21

SEC v. Garfinkle, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,465 (S.D.N.Y. June 9, 1978) 28

SEC v. National Sec., Inc., 393 U.S. 453 (1969) 11, 37-38

SEC v. W.J. Howey Co., 328 U.S. 293 (1946) ..... *passim*

SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976) 21

Secon Serv. Sys., Inc. v. St. Joseph Bank & Trust Co., 855 F.2d 406 (7th Cir. 1988) 32-33

Securities Industry Ass'n v. Board of Governors, 468 U.S. 137 (1984) 18-19

Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479 (1985) 14

Sturdivant v. McCorley, 83 Ark. 278, 103 S.W. 732 (Ark. 1907) 10

Tcherepnin v. Knight, 389 U.S. 332 (1967) 29

Teamsters v. Daniel, 439 U.S. 551 (1979) 12, 13, 29

Union Nat'l Bank v. Farmers Bank, 786 F.2d 881 (8th Cir. 1986) 20, 21

Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc., 651 F.2d 1174 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981) 36

United California Bank v. THC Fin. Corp.,
557 F.2d 1351 (9th Cir. 1977).....20

United Housing Found., Inc. v. Forman,
421 U.S. 837 (1975).....*passim*

United States v. James, 478 U.S. 597 (1986).....14

United States v. Ron Pair Enterprises, Inc.,
109 S. Ct. 1026 (1989).....13

Williamson v. Tucker, 645 F.2d 404 (5th Cir.),
cert. denied, 454 U.S. 897 (1981).....25

*Windon Third Oil & Gas Drilling Partnership v.
FDIC*, 805 F.2d 342 (10th Cir. 1986), *cert. denied*,
480 U.S. 947 (1987).....4

Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974)..... 25-26, 42

Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795
(2d Cir.), *cert. denied*, 414 U.S. 908 (1973).....11, 17, 20

Zuber v. Allen, 396 U.S. 168 (1969).....14

Statutes

Arkansas Securities Act, Ark. Stat. Ann. § 67-1256..... 4

Glass-Steagall Act, ch. 89, 48 Stat. 162.....18, 19

Securities Act of 1933, 15 U.S.C. 77a *et seq.*:
§ 2(1), 15 U.S.C. 77b(1)..... 15, 23
§ 3(a)(3), 15 U.S.C. 77c(a)(3).....15-16, 18
§ 12(2), 15 U.S.C. 77*l*(2).....21

Securities Exchange Act of 1934, 15 U.S.C. 78a
et seq.:
§ 3(a)(10), 15 U.S.C. 78c(a)(10).....*passim*
§ 10(b), 15 U.S.C. 78j(b).....4

Public L. 97-303 (1982)..... 14

Miscellaneous

Ahlburg, *The Status of Note Participations under the
Federal Securities Acts*, 8 HARV. J.L. & PUB
POL'Y 465 (1985)..... 28

Annotation, *When Statute of Limitations Begins to Run
against Note Payable on Demand*, 71 A.L.R.2d 284
(1960)..... 10

BARRON'S FINANCE & INVESTMENT HANDBOOK
(2d ed. 1986).....34

Comment, *Commercial Notes and Definition
of "Security" under Securities Exchange
Act of 1934: A Note Is a Note Is a Note?*,
52 NEB. L. REV. 478 (1973).....20, 26, 42

Dillpon, *Restoring Balance to the Definition of
Security*, 10 SEC. L.J. 99 (1982)..... 25

Fitzgibbon, *What Is a "Security": A Redefinition
Based on Eligibility to Participate in the Financial
Markets*, 64 MINN. L. REV. 839 (1980)..... 25, 28

Freeman, *A Study in Contrasts: The Warren and
Burger Courts' Approach to the Securities Laws*,
83 DICK. L. REV. 183 (1978)..... 12

Glidden, *When Are Loans Security Transactions? A Proposed Test*, 13 SEC. REG. L.J. 212 (1985)..... 26, 28

Gudridge, *Legislation in Legal Imagination: Introductory Exercises*, 17 U. MIAMI L. REV. 493 (1983)..... 38

INVESTMENT & SECURITIES DICTIONARY (1986)..... 34

Jones, *Footnote 11 of Marine Bank v. Weaver: Will Unconventional Certificates of Deposit Be Held Securities?*, 24 HOUS. L. REV. 491 (1987)..... 24

Lizzul, *The Evolution of Bank Term Lending and the Status of Term Notes under the Federal Securities Laws*, 31 SYRACUSE L. REV. 959 (1980)..... 22, 25, 26, 27

L. Loss, FUNDAMENTALS OF SECURITIES REGULATION (2d ed. 1988)..... 34

2 L. Loss & J. Seligman, SECURITIES REGULATION (3d ed. 1989)..... 25, 26

Lowenfels, *Recent Supreme Court Decisions under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891 (1977)..... 12

G. Munn & F. Garcia, ENCYCLOPEDIA OF BANKING & FINANCE (8th ed. 1983)..... 34

2 THE NEW PALGRAVE -- A DICTIONARY OF ECONOMICS (1987)..... 34

Note, *Notes as Securities under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 MD. L. REV. 233 (1977)..... 25, 42

Note, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362 (1972)..... 16

Rosin, *Historical Perspective on the Definition of a Security*, 28 S. TEX. L. REV. 577 (1987)..... 38

Securities Act Release No. 33-4412, 17 C.F.R. § 231.4412 (1961)..... 16

Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. L. 1567 (1980)..... 26, 27

S. Rep. No. 792, 73d Cong. 2d Sess. (1934)..... 17

Steinberg, *The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489 (1987)..... 38

Whitaker & Rotch, *The Supreme Court and the Counterrevolution in Securities Regulation*, 30 ALA. L. REV. 335 (1979)..... 12

STATEMENT OF THE CASE

Farmers Co-Op of Arkansas and Oklahoma (the "Co-Op") was in most respects indistinguishable from the thousands of other agricultural co-operatives across rural America. Unlike others, however, it borrowed from its members and gave them promissory notes payable on demand. The question before the Court is whether those demand notes are securities.

THE DEMAND NOTE PROGRAM

Members who sold their crops through the Co-Op and bought their supplies from it also supported it by participating in the Co-Op's demand note program whereby the Co-Op used members' funds for ongoing operations and capital expenditures and gave the members notes that were payable on demand. These notes were generally sold only to members of the Co-Op, although occasionally non-members also participated.[1]

As the demand note reprinted in the Joint Appendix (J.A. 4) demonstrates, these were simple instruments, more like deposit slips than the elaborate notes sometimes used to evidence investments. The principal due the Co-Op member was fixed when the note was issued and that amount, plus

---

[1] Petitioners and the amici claim again and again that the notes were sold to the general public, suggesting a broad-scale solicitation of investments by the Co-Op. *See, e.g.*, Brief for the Petitioners ("Pet. Br.") at 13; Brief for the Securities and Exchange Commission ("SEC Br.") at 10; Brief for the North American Securities Administrators Association, Inc. ("NASAA Br.") at 5. In most instances the note holders were Co-Op members, who were certainly not strangers to their own Co-Op. Because the demand note program was publicized only in the newsletter the Co-Op sent to its own members, any non-members who held notes either had a business connection with the Co-Op or a relationship with its members. The Co-Op was clearly not seeking funds from the general public.

interest, was payable any time the member wanted it. The interest rate was periodically adjusted so that it remained just above that being paid by local banks and savings institutions.

Members used the demand notes like passbook savings accounts that are available at savings and loan associations and commercial banks. Some made frequent "deposits" and "withdrawals," while others left their funds with the Co-Op to accumulate interest. When a note holder deposited additional funds, he or she received a new note in the amount of the deposit and, when funds were withdrawn, the existing note was returned to the Co-Op and replaced with one reflecting the balance left after the withdrawal.

The Co-Op achieved lower interest costs through the demand notes than it would have incurred through borrowings from banks, larger co-operatives and other lending sources and, at the same time, its members realized a higher rate of return than they could have obtained as depositors at local banks and savings institutions.

THE ROLE OF ARTHUR YOUNG

Arthur Young, a partnership of certified public accountants now known as Ernst & Young, audited the Co-Op's 1981 and 1982 financial statements and issued its reports on those statements to the Co-Op's management and directors. Prior auditors had permitted most of the demand notes to be classified as long-term liabilities. Arthur Young refused to accept that treatment because all of the demand notes could have been presented for payment at any time. Management reluctantly acquiesced and showed all the demand notes as current liabilities on the Co-Op's 1981 and 1982 financial statements. *See* 1982 Co-Op financial statements which, together with Arthur Young's audit report, have been lodged with the Clerk of the Court. Arthur Young also urged the

Co-Op's management and directors to reduce its dependence on demand notes but that advice was ignored.

In addition, Arthur Young required the Co-Op to make extensive other new disclosures in its financial statements and, even then, issued heavily qualified audit reports to the Co-Op's management and directors. Despite Arthur Young's suggestions, the Co-Op never disseminated the financial statements audited by Arthur Young to its members. The only financial information any members received was the condensed financial statements prepared by the Co-Op's management and made available only to the approximately 350 members -- out of a total of 23,000 -- who attended the Co-Op's annual meetings. There was no evidence that anyone who attended those meetings and thus saw Co-Op financial information also participated in the demand note program.[2]

THE CASE BELOW

Early in 1984 the Co-Op filed for protection under the federal bankruptcy laws. At that time about 7% of its members held approximately $10 million in demand notes. In early 1985 the trustee in bankruptcy and a class of note holders filed suit against scores of persons and entities, including Arthur Young. Dozens of federal and state law claims were asserted, including several under federal and state securities law theories.

---

[2] Petitioners are absolutely wrong in asserting that condensed financial statements were mailed to the Co-Op's members. Pet. Br. at 5-6. There is no evidence that condensed financial statements were ever mailed; in fact, they were distributed only to those few members who attended the Co-Op's annual meetings. Transcript 14:56-58. Petitioners are also wrong in their claim that Arthur Young prepared the audited and condensed financial statements. *See* Pet. Br. at 5, 10. As petitioners' expert acknowledged at trial, the Co-Op, like any business, prepared its own financial statements and Arthur Young, like any auditor, examined those statements and opined on them. Transcript 14:281-82.

Most of the claims against Arthur Young were dismissed or disposed of by summary judgment. The trial court, however, declined to dismiss the securities law claims despite Arthur Young's argument, *inter alia*, that the demand notes were not securities.

Although the claims against other defendants were settled, with the class recovering approximately $5,775,000 in that manner, the case against Arthur Young was tried on several common law theories asserted by the trustee and on the class' claims under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (the "1934 Act"), and section 67-1256 of the Arkansas Securities Act. Arthur Young prevailed on the trustee's claims and the class prevailed on its claims against Arthur Young, receiving a $6,100,000 rescission verdict that was reduced to approximately $375,000 by credits for the settlement payments the class had received from other defendants.

All parties appealed, with Arthur Young raising a number of very serious errors, including the trial court's determination that the demand notes were securities.[3] The

---

[3] The most striking of the trial court's other errors was its permitting the class claim under section 10(b) to go to the jury. No information emanating from Arthur Young was ever communicated to the class and most of its members had apparently never heard of Arthur Young. Further, because Arthur Young was not a fiduciary to the class, it had no duty to communicate with the members of the class. *See, e.g., Chiarella v. United States*, 445 U.S. 222 (1980); *Windon Third Oil & Gas Drilling Partnership v. FDIC*, 805 F.2d 342 (10th Cir. 1986), *cert. denied*, 480 U.S. 947 (1987); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986). Arthur Young also attacked the state blue sky verdict on the grounds that the statute did not permit the theories asserted under it by petitioners. As to both federal and state claims, Arthur Young argued that there was no evidentiary support for the damages award, that the wrong measure of damages was applied and that no class should have been certified.

Eighth Circuit found it unnecessary to reach any of the other issues raised by Arthur Young. Using an approach based on *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), the court of appeals concluded that, because the demand notes were not securities under either federal or state law, they could not support a securities fraud claim. Pet. App. A23, A25.

The Eighth Circuit first determined that, although the demand notes had a name -- notes -- traditionally associated with a security, they did not have all of the required characteristics of a note that meets the statutory definition of a security because of their demand nature. Pet. App. A20. The court then applied the test developed in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946): whether the transaction "involves an investment of money in a common enterprise with profits to come solely from the efforts of others." It concluded, first, that the "investment of money" element of the test could not be satisfied because the demand notes were more like loans than investments and, second, that the notes' fixed interest rate did not evidence an anticipation of profit, as the Court had used that phrase in *Howey* and later in *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975). Pet. App. A21-A23.

The Eighth Circuit held:

> Because these demand notes were uncharacteristic of securities, and also failed the *Howey* test, we conclude that they were not securities within the meaning of the Federal Act. The Class has thus failed to state a claim under section 10(b) of the Federal Act, 15 U.S.C. § 78j(b).

Pet. App. A23. The class' petition for rehearing *en banc* was denied. *Id.* at A2.

SUMMARY OF ARGUMENT

The demand notes are simple instruments. Apparently adapted from a stationery store form, *see* J.A. 4, they are closer to traditional savings accounts than to the elaborate, long-term corporate notes that are indisputably securities.

These demand notes are not securities, as defined in section 3(a)(10) of the 1934 Act, for two reasons. First, they fit within the explicit statutory exclusion for notes with "a maturity at the time of issuance of not exceeding nine months." Second, even if the exclusion were not applicable, they are not securities under the framework articulated by the Court in *Landreth* because they neither have the requisite characteristics nor satisfy the *Howey* test.

Petitioners and the SEC seek to avoid the absolutely plain meaning of the definitional exclusion for short-term notes by invoking the legislative history of an exemption from registration section in the Securities Act of 1933, 15 U.S.C. § 77a *et seq*. (the "1933 Act"), and an SEC interpretation of that exemption limiting its application to certain short-term commercial paper. However, legislative history of a 1933 Act exemption of certain short-term notes from registration and the SEC's interpretation of that provision have no relevance to an analysis of a very different provision -- a total exclusion of short-term notes from the definition of "security" -- in a different statute, the 1934 Act.

The SEC and, now for the first time in this litigation, petitioners would have the Court adopt the Second Circuit's "family resemblance" test for determining what notes are securities. *See Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976). This test is a definition-by-default: the Second Circuit simply created, without reference to any statutory language or stated rationale, a list of notes that are

not securities and ruled that all notes not bearing a "family resemblance" to those few examples *are* securities.

The family resemblance test is at odds with the Court's definitional approach reflected in a line of cases including *Forman* and *Landreth*. Moreover, its use would create the uncertainty decried in *Landreth* because the test does not articulate a basis for distinguishing those notes that are securities from those that are not. As a result, the lower courts can add or subtract instruments from the *Exchange National Bank* list at whim.

Far better is an approach based on the Court's *Howey*, *Forman* and *Landreth* decisions. It starts with the statutory language and examines, as *Forman* and *Landreth* suggest, the characteristics of the note in question. This approach compares the note's characteristics with those of other debt instruments that are enumerated in the definition of "security" and that are undeniably securities, such as long-term corporate bonds and debentures. If the note does not have the same characteristics as bonds and debentures, it is evaluated under the *Howey* test, which the Court prescribed in *Landreth* for instruments "of more variable character" than those "whose names alone carry well-settled meaning."

Unlike the family resemblance test, this is a positive approach based on the statutory language. It operates in a framework that has been designed by the Court in a series of carefully considered decisions; it offers a measure of certainty to the lower courts and practitioners; it brings to bear more than forty years of precedent interpreting the elements of the *Howey* test; and it encompasses all 1934 Act definitional questions in one objective, workable framework.

The demand notes in this case, being immediately payable, non-negotiable instruments, have none of the characteristics of those long-term, publicly-traded corporate

bonds and debentures that are indisputably securities. Further, they do not pass the *Howey* test because their instant liquidity precludes their treatment as investments and their fixed rate of return does not reflect the capital appreciation or participation in earnings required under *Howey* and *Forman*.

Even under the family resemblance test, should the Court adopt it, the demand notes are not securities. As the SEC has noted, *see* SEC Br. at 17, there is at least a presumption that, given their short term, demand notes are not securities. This presumption cannot be overcome because demand notes bear a closer resemblance to passbook savings accounts, which are not securities, than to bonds and debentures, which are.

The essence of Ernst & Young's position is that the Court should conclude that the demand notes are not securities, either by enforcing the plain meaning of the statutory exclusion for short-term instruments or by employing the framework the Court developed in *Forman* and *Landreth*.

By urging the Court to ignore the plain meaning of the statutory exclusion and to apply the family resemblance test, petitioners and the SEC are, in effect, asking the Court to rewrite for Congress an important portion of the definition of "security." The statutory definition provides:

> [S]ecurity means any note . . . but shall not include currency or any note . . . which has a maturity at the time of issuance of not exceeding nine months.

If the Court adopts the family resemblance test, as urged by petitioners and the SEC, the Court will have rewritten the definition to read as follows:

> [S]ecurity means any note . . . but shall not include (1) short-term commercial paper, (2) notes delivered in consumer financing, (3) notes secured by a home mortgage, (4) notes secured by a lien on a small business or some of its assets, (5) notes evidencing character loans to a bank customer, (6) notes secured by an assignment of accounts receivable, (7) notes formalizing an open-account debt incurred in the ordinary course of business, or (8) notes evidencing loans by commercial banks for current operations.

Neither law nor policy supports such a radical judicial revision of Congress' chosen language.

ARGUMENT

I.

THE 1934 ACT, BY ITS TERMS, REQUIRES THAT THESE DEMAND NOTES BE HELD NOT TO BE SECURITIES

The definition of "security" in section 3(a)(10) of the 1934 Act explicitly excludes demand notes. Petitioners and their amici argue only in passing that the language of the statutory exclusion does not apply specifically to demand notes. Rather, most of their effort is aimed at eviscerating the exclusion by construing it in light of the legislative history of a very different section of another statute.

A. *The Language of the 1934 Act Excludes Demand Notes from the Definition of "Security"*

Section 3(a)(10) of the 1934 Act is remarkably straightforward:

> When used in this chapter, unless the context otherwise requires --
>
> * * *
>
> (10) The term "security" means any note, stock, treasury stock, bond, debenture. . .; *but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.*

15 U.S.C. § 78c(a)(10) (emphasis added). Because demand notes, by definition, have a maturity of less than nine months, they are, under the explicit language of the statute, not securities.

1. Demand Notes Fall Squarely within the Nine-Month Exclusion and That Result Is Not Affected by the "Context" Clause

The SEC, citing no authority, suggests that a demand note has an indefinite term and therefore may not be "regarded as having a fixed term of less than nine months for purposes of the federal securities laws." SEC. Br. at 24. However, the exclusion in section 3(a)(10) focuses, not on the term of an instrument, but on its "maturity at the time of issuance." Arkansas law, which governs these notes, is in conformity with the common law rule: "A note payable on demand is due immediately." *McMahon v. O'Keefe*, 213 Ark. 105, 209 S.W.2d 449, 450 (Ark. 1948). *Accord Sturdivant v. McCorley*, 83 Ark. 278, 103 S.W. 732, 733 (Ark. 1907). *See generally* Annotation, *When Statute of Limitations Begins to Run against Note Payable on Demand*, 71 A.L.R.2d 284 (1960). That the due, or maturity, date of demand notes is

immediate demonstrates that they fall within the nine-month exclusion.

The SEC also argues that the prefatory phrase in section 3(a), "unless the context otherwise requires," permits a court to ignore the explicit exclusion of *all* short-term notes from the 1934 Act's definition of "security" and, in the interest of "flexibility," to limit the exclusion to certain select short-term notes. *See* SEC Br. at 17-18. Where a provision is as specific as this exclusion, a general "context" clause cannot be used to justify a court's rewriting of it. *See SEC v. National Sec., Inc.*, 393 U.S. 453, 466 (1969).

2. The Court Should Enforce the Plain Language of the Nine-Month Exclusion

Petitioners and the SEC urge this Court to adopt a construction of section 3(a)(10) that the lower federal courts have employed over the last two decades in virtually eliminating the short-term note exclusion from section 3(a)(10) of the 1934 Act. *See, e.g., McClure v. First Nat'l Bank*, 497 F.2d 490, 494-95 (5th Cir. 1974); *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 799-800 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1079-80 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

McClure is an excellent example of a method of interpretation consistently adopted by the lower federal courts and consistently rejected in this Court. In that case the Fifth Circuit concluded that "the [1934] Act covers all investment notes, no matter how short their maturity." 497 F.2d at 494. In a brutally honest passage, Judge Roney said:

> Thus, the investment or commercial nature of a note entirely controls the applicability of the Act, depriving of all utility the exemption based on maturity-length. The original scrivener of the definitional section may well wonder what

happened to his carefully drawn exemption on the way to the courthouse.

Id. at 495.[4]

At the same time that the lower federal courts were dismembering the clear nine-month exclusion in section 3(a)(10) of the 1934 Act, this Court was, as many commentators have noted,[5] consistently narrowing the application of the federal securities laws.[6] In those cases the

---

[4] Judge Roney added that it was for Congress to "rectify the situation" if court decisions did not reflect congressional intent and if "the Supreme Court does not make some definitive decision contrary" to those decisions. 497 F.2d at 495. This case presents the Court with the opportunity to make that definitive decision.

[5] *See* Lowenfels, *Recent Supreme Court Decisions under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891, 892, 920-21 (1977); Whitaker & Rotch, *The Supreme Court and the Counterrevolution in Securities Regulation*, 30 ALA. L. REV. 335, 336-37, 393-94 (1979). *See generally* Freeman, *A Study in Contrasts: The Warren and Burger Courts' Approach to the Securities Laws*, 83 DICK. L. REV. 183, 193-206 (1978).

[6] *See, e.g., Pinter v. Dahl*, 108 S. Ct. 2063 (1988), *reversing* 857 F.2d 262 (5th Cir. 1988) (narrowing the definition of "seller" under section 12(1) of the 1933 Act); *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), *reversing in part, affirming in part* 485 F.2d 224 (6th Cir. 1986) (narrowing of scope of materiality test with respect to disclosure of merger negotiations); *Marine Bank v. Weaver*, 455 U.S. 551 (1982), *reversing* 637 F.2d 157 (3d Cir. 1978) (certificate of deposit and participation agreement not securities); *Chiarella v. United States*, 445 U.S. 222 (1980), *reversing* 588 F.2d 1358 (2d Cir. 1978) (narrowing insider trading liability); *Teamsters v. Daniel*, 439 U.S. 551 (1979), *reversing* 561 F.2d 1223 (7th Cir. 1977) (pension interests not securities); *Redington v. Touche Ross & Co.*, 443 U.S. 904 (1979), *reversing* 592 F.2d 617 (2d Cir. 1976) (restricting implied rights of action under the 1934 Act); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), *reversing* 533 F.2d 1283 (2d Cir. 1976) (restricting application of section 10(b) of the 1934 Act); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), *reversing* 503 F.2d 1100 (7th

Court repeatedly emphasized that "[t]he starting point in every case involving construction of a statute is the language itself." *Landreth*, 471 U.S. at 685, quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring). *Accord Teamsters v. Daniel*, 439 U.S. 551, 585 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977).[7] Of critical importance in such an approach is "the definitional section [and the] carefully drawn exemption" as "[t]he original scrivener" set them down.

In this case, the analytical starting point is the language of the exclusion in section 3(a)(10), which specifically covers notes with "a maturity at the time of issuance of not exceeding nine months." The Court has repeatedly said it will enforce the plain meaning of a statute and it is difficult to envision words of plainer meaning than this exclusionary language.

Earlier this year the Court again restated the "plain language" rule: "[W]here, as here, the statute's language is plain, 'the sole function of the courts is to enforce it according to its terms.'" *United States v. Ron Pair Enterprises, Inc.*, 109 S. Ct. 1026, 1030 (1989), quoting *Caminetti v. United States*, 242 U.S. 470, 485 (1917). As the Court said in *Commissioner v. Asphalt Prod. Co.*, 482 U.S. 117, 121 (1987), "[j]udicial perception that a particular result would be unreasonable may enter into the construction of ambiguous provisions, but cannot justify disregard of what Congress has plainly and intentionally provided." *Accord Chan v. Korean Air Lines, Ltd.*, 109 S. Ct.

Cir. 1974) (restrictive fault standard under section 10(b)); *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975), *reversing* 500 F.2d 1246 (2d Cir. 1974) (narrowing definition of "security").

[7] Under this approach the only instruments the Court has found to be securities since 1975 were traditional business corporation stock, the "paradigm of a security." *See Landreth*, 471 U.S. at 685; *Gould v. Ruefenacht*, 471 U.S. 701 (1985).

1676, 1683-84 (1989); *United States v. James*, 478 U.S. 597, 604 (1986); *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 499-500 (1985).

No amount of case law in the lower courts will save an interpretation that contradicts the plain meaning of the statute. *McLaughlin v. Richland Shoe Co.*, 108 S. Ct. 1677, 1681 (1988); *Bourjaily v. United States*, 483 U.S. 171, 178 (1987). If the statute is clear, its legislative history, even if contradictory, is irrelevant. *Davis v. Michigan Dept. of Treasury*, 109 S. Ct. 1500, 1504 n.3 (1989). *Accord Blanchard v. Bergeron*, 109 S. Ct. 939, 946-47 (1989) (Scalia, J., concurring). As Justice Scalia said, concurring in *Pennsylvania v. Union Gas Co.*, 109 S. Ct. 2273, 2296 (1989), "[i]t is our task, as I see it, not to enter the minds of the Members of Congress -- who need have nothing in mind in order for their votes to be both lawful and effective -- but rather to give fair and reasonable meaning to the text of the United States Code."[8]

Thus, any resort to legislative history is not only unnecessary but also unwarranted where, as here, the statutory language is plain and unambiguous. The clear words of section 3(a)(10) exclude from the definition of "security" notes with a maturity of nine months or less. As applied to this case, the exclusion compels the determination that the demand notes are not securities.

---

[8] The doctrine of legislative ratification cannot be invoked to conform section 3(a)(10) to the judicial interpretation advanced by petitioners. Although the section has been amended in recent years, *see* Pub. L. 97-303 (1982), nothing in the legislative history of that amendment indicates that Congress gave any consideration at all to the nine-month exclusion. Absent evidence of focused attention on the particular provision at issue, the legislative ratification doctrine is inapplicable. *See, e.g., Patterson v. McLean Credit Union*, 109 S. Ct. 2363, 2372 n.1 (1989); *Barrett v. United States*, 423 U.S. 212, 223-24 (1976); *Zuber v. Allen*, 396 U.S. 168, 193 (1969); *Girouard v. United States*, 328 U.S. 61, 69-70 (1946).

3. No Legislative History Supports the Treatment of Demand Notes as Securities

There is yet a further reason why resort to legislative history is unwarranted in this case. Contrary to the impression that petitioners and the SEC try to convey, there is no legislative history of the 1934 Act's nine-month exclusion. Instead, the legislative history cited by the lower courts, petitioners and the amici to support their interpretation of the nine-month exclusion relates to different language in a different statute, the 1933 Act, and is directly at odds with the language of the 1934 Act.

As indicated above, the 1934 Act definition of "security" contains an explicit exclusion for all short-term notes. By contrast, the 1933 Act defines "note" as a "security" without any exclusion. *See* 1933 Act § 2(1).[9] The 1933 Act does, however, provide in a separate section, section 3, that certain specified securities are exempt from the Act's registration requirement. Relevant to this case is section 3(a)(3), which exempts:

> [a]ny note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

---

[9] Although the Court has noted that the definitions of "security" in section 3(a)(10) of the 1934 Act and section 2(1) of the 1933 Act are "virtually identical," *Landreth*, 471 U.S. at 685 n.1, the issues in this case revolve around the one portion that is *not* identical: the language in section 3(a)(10) excluding short-term notes from the definition of "security," which has no counterpart in section 2(1). The Court has not until now considered a case where the part of section 3(a)(10) that is not "virtually identical" to section 2(1) was relevant.

15 U.S.C. § 77c(a)(3). Thus, while the 1934 Act *totally* excludes all short-term notes from its coverage, the 1933 Act exempts only certain of such notes from only one of its provisions.

Relying heavily on the legislative history of the 1933 Act, the Securities and Exchange Commission has construed the exemption from registration in section 3(a)(3) of the 1933 Act to apply only to short-term commercial paper, Securities & Exchange Comm'n, Securities Act Release No. 33-4412, 17 C.F.R. § 231.4412 (1961), and it is commonly known today as the "commercial paper" exemption. *See generally* Note, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362 (1972).

The critical phrase in section 3(a)(3) of the 1933 Act, which does not appear in the 1934 Act and which the SEC uses as the basis for its "commercial paper" interpretation, is: "which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions." The SEC's interpretation of the phrase "current transaction" in section 3(a)(3) of the 1933 Act has absolutely no bearing on the correct interpretation of a definition in the 1934 Act that does not even contain that phrase.[10]

Nothing meaningful in the legislative history of the 1934 Act addresses how section 3(a)(10) was constructed. The Senate Report simply states that the "issuer" and "security"

---

[10] Even in a 1933 Act case, the SEC's interpretation of the section 3(a)(3) exemption should not receive the deference frequently accorded agency pronouncements, *see, e.g., Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984), because it is so much more restrictive than the statute that it contradicts the plain meaning of section 3(a)(3). *See Pittston Coal Group v. Sebben*, 109 S. Ct. 414, 420 (1988) ("[T]he statute simply will not bear the meaning the Secretary has adopted."); *Bethesda Hosp. Ass'n v. Bowen*, 108 S. Ct. 1255, 1258 (1988).

definitions "are substantially the same as those in the Securities Act of 1933." S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934). The Report is, of course, correct; they are *substantially* the same. There is, in fact, only one difference -- the exclusionary language at issue here.

The Seventh Circuit was the first court to perform the judicial alchemy of transforming the legislative history underlying the exemption-from-registration section of the 1933 Act into the basis for construing the exclusion contained in the definitional section of the 1934 Act. *See Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972). Its approach has been followed by numerous other courts. *See, e.g., Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 800 (2d Cir. 1973); *Bellah v. First Nat'l Bank*, 495 F.2d 1109, 1111 (5th Cir. 1974).

In *Sanders* the Seventh Circuit passed off the differences between the exclusion in the 1934 Act and the exemption in the 1933 Act by saying only:

> [P]laintiff and his class purchased the kind of "security" in regard to which the securities acts were intended to offer protection against fraud, misrepresentation and nondisclosure. Five of those acts expressly did so. We believe Congress intended to protect against fraud the purchasers of securities such as those involved here under the 1934 act as well.

463 F.2d at 1079-80 (footnote omitted). The court concluded, with remarkable certainty given the absence of legislative history: "[W]hen Congress spoke of notes with a maturity of not exceeding nine months, it meant commercial paper, not investment securities." *Id.* at 1080 (footnote omitted).

Just as the Seventh Circuit expressed this conclusion with no supporting authority, so also petitioners and the SEC

characterize the 1934 Act's nine-month exclusion as "the exemption for commercial paper," Pet. Br. at 35, and try to pass off the 1933 Act's legislative history as "appl[ying] equally" to the nine-month exclusion in the 1934 Act. SEC Br. at 21. Not only are petitioners and the SEC disingenuous in so characterizing the exclusion, but they also are apparently unable to advance *any* reason why the 1933 Act's legislative history for the exemption from registration of certain notes *should* "apply equally" to the 1934 Act's exclusion of all short-term notes from the definition of "security."

Even assuming that Congress in 1933 intended to exempt only certain "commercial paper" from the 1933 Act's registration requirement and expressed that intention through the term "current transactions," its choice in the following year not to include that term in the 1934 Act's nine-month exclusion can only mean that it was creating a definitional exclusion that was both broader and differently focused than the registration exemption in the 1933 Act.

Petitioners and the SEC also try to create the impression that the Court passed on this question in *Securities Industry Ass'n v. Board of Governors*, 468 U.S. 137 (1984). The SEC, for example, says that "both this Court and the lower courts have uniformly construed the exemption" in sections 3(a)(10) and 3(a)(3) to refer only to commercial paper. SEC Br. at 14. The SEC adds, "[i]n so ruling they have relied on the legislative history of the exemption . . . and on the SEC's consistent and longstanding interpretation of this provision." *Id.* at 15.

In *Securities Industry Association*, the Court held only that "commercial paper," as that term is used in the Glass-Steagall Act, ch. 89, 48 Stat. 162, codified as amended in scattered sections of 12 U.S.C., is a security that cannot be marketed by commercial banks. In a footnote the Court said only that section 3(a)(10) "exempt[s] certain 'note[s]' with

maturities of less than nine months from the definition of 'security' under the Securities Exchange Act of 1934." 468 U.S. at 151 n.7. The Court did *not* hold that the nine-month exclusion is limited to commercial paper. It also neither equated the exemption in the 1933 Act and the exclusion in the 1934 Act nor concluded that either was limited to commercial paper.[11] In short, the Court simply has not spoken to this issue.

Petitioners and the SEC are absolutely wrong in trying to apply the legislative history of a different section of a different statute to the exclusionary language of section 3(a)(10). The exclusion should be applied as plainly written. The demand notes here, having a maturity of less than nine months, cannot be securities under the 1934 Act.

B. *No Policy Considerations Militate Against Applying the 1934 Act As Written*

Not only does the statutory analysis above make manifest that demand notes are not securities but, further, no public policy interests require vindication at the expense of sound statutory construction. Reversing the lower courts' practice of ignoring the nine-month exclusion will bring certainty and predictability to this subject without causing any significant change in the substantive body of note-as-a-security law.

---

11 If anything, *Securities Industry Association* supports Ernst & Young's position. In that case, the Federal Reserve Board urged the Court to adopt a narrow construction of the terms "security" and "note" in the Glass-Steagall Act in order to exclude commercial paper. The Court rebuffed the Board's argument, reasoning that "[w]ithout some clearer directive from Congress . . . we cannot endorse the Board's departure from the literal meaning of the Act." 468 U.S. at 153.

There has been relatively little litigation over notes with a maturity of nine months or less.[12] In fact, petitioners cite only one case that, even arguably, involved demand notes.[13] Thus, there is a hollow ring to the alarm that petitioners and their amici sound of securities fraud run rampant if demand notes are held not to be securities. *See, e.g.,* Brief for the Arkansas Securities Commissioner ("Ark. Br.") at 7; NASAA Br. at 6-7. There is simply no history of wide-spread fraud committed through such instruments and neither petitioners nor their amici have demonstrated that perpetrators of fraud will suddenly rush to such schemes if demand notes are held not to be securities.[14]

---

[12] Even though they may have ignored the principles of statutory construction discussed above, a number of courts have held certain short-term notes not to be securities on other grounds. *See, e.g., Union Nat'l Bank v. Farmers Bank*, 786 F.2d 881 (8th Cir. 1986) (participation in six-month note); *American Bank & Trust Co. v. Wallace*, 702 F.2d 93 (6th Cir. 1983) (thirty-day promissory note in commercial loan transaction); *United California Bank v. THC Fin. Corp.*, 557 F.2d 1351 (9th Cir. 1977) (one-month note and six-month put between bank and customer); *Bellah v. First Nat'l Bank*, 495 F.2d 1109 (5th Cir. 1974) (six-month note secured by deed of trust on livestock business).

[13] In *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973), the court's characterization of the instrument at issue in that case as a "demand note" seems questionable in light of the court's observation that "the maker of the note [the parent of the holder] *could prevent any demand* by the holder." 476 F.2d at 799 (emphasis added). Even assuming that the note was a true demand note, the opinion contains no analysis of the effect of the demand feature on the question whether the note should be treated as a security. The flaws in *Zeller* are analyzed in Comment, *Commercial Notes and Definition of "Security" under Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 NEB. L. REV. 478, 522 n.166 (1973).

[14] Only a daring or foolish con man would effect a fraudulent scheme through demand notes -- putting himself at constant risk of a "run" on his funds -- when, with longer-term instruments, he would have greater

Should the parade of horribles envisioned by petitioners and their amici ever materialize, regulators and investors will not be defenseless.[15] In addition to the antifraud provisions of the 1933 Act, which the SEC has vigorously asserted in the past, *see, e.g., SEC v. World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976); *SEC v. First American Bank & Trust Co.*, 481 F.2d 673 (8th Cir. 1973), there are injunctive and damage remedies available under state law.[16]

There is also a simpler, more direct answer to the concerns raised by petitioners and their amici. If, as the statute clearly states, these demand notes are not securities, the only consequence is that any fraud committed in connection with their purchase or sale is not securities fraud. There is wide-spread use of written instruments, including those denominated notes, in such endeavors as banking, credit card sales and door-to-door selling; yet their susceptibility to being vehicles of fraud does not make them securities. The court of appeals in this case was simply echoing this Court when it noted Congress' "intent not to provide a broad federal remedy for all fraud." Pet. App. A19, quoting *Union Nat'l Bank v. Farmers Bank*, 786 F.2d 881, 884 (8th Cir. 1986). *Accord Landreth*, 471 U.S. at 687-88; *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982).

The SEC's primary concern appears to be that unsophisticated persons unfamiliar with an entity need the full

---

opportunity to accumulate more victims' funds and to perpetuate his scheme.

[15] As indicated *supra* at 15, the 1933 Act *definition* has no short-term exclusion, with the result that, for purposes of that Act, many short-term notes are securities and are subject to its antifraud provisions. *See infra* note 18.

[16] For example, section 12(2) of the 1933 Act, 15 U.S.C. § 77*l*(2), and its state law counterparts prohibit fraudulent practices by those primarily involved in selling securities. *See, e.g., Pinter v. Dahl*, 108 S. Ct. 2063 (1988).

benefit of both the disclosure provided by a registration statement and the protection of the antifraud provisions of the federal securities laws. *See* SEC Br. at 24. Here, the note holders were not strangers to their own Co-Op. They were, almost entirely, farmers who sold crops through, and bought supplies from, the Co-Op. They knew the organization and its operations. As members, with a need for the marketing and purchasing power that comes from participation in a co-operative, they had an interest in the financial well-being of the Co-Op. They served themselves and the Co-Op by participating in the demand note program.

There can never be a perfect delineation of what notes are securities; there are simply too many variables for a rule to be crafted that draws precisely the right line for every case. It is apparent that Congress, in choosing the words it did in the exclusionary language of section 3(a)(10), made a somewhat arbitrary, but nonetheless clear, distinction: a note with a maturity of nine months or less is not a security.[17]

Particularly in light of the small number of short-term notes that have been held to be securities, what is arguably lost in fine-tuning is more than compensated for in certainty. One great virtue in applying the statute as written is the bright line it provides and the predictability that comes with it. *See Landreth*, 471 U.S. at 696-697.

In any event, Congress has made the choice. It has opted for the certainty of a clear exclusion of all short-term

---

17 The distinction accords with practice at the time the securities laws were adopted. Short-term notes were used in bank lending, almost to the exclusion of long-term instruments, because they provided high liquidity. *See* Lizzul, *The Evolution of Bank Term Lending and the Status of Term Notes under the Federal Securities Laws*, 31 SYRACUSE L. REV. 959, 967 (1980). As Lizzul points out, "the concept of liquidity serves as the distinction between security and nonsecurity notes." *Id.* at 1005. That concept is embodied in the nine-month exclusion.

notes from the definition of "security."[18] That the federal and state regulators would like the statute to have no time threshold for notes as securities is of little moment. Given the plain language of the short-term note exclusion in the statute, they should be asking Congress, not the Court, to rewrite section 3(a)(10). *See H.J. Inc. v. Northwestern Bell Tel. Co.*, 109 S. Ct. 2893, 2905 (1989) ("RICO may be a poorly drafted statute; but rewriting it is a job for Congress, if it is so inclined, and not for this Court.").

II.

ALTERNATIVELY, THE COURT SHOULD APPLY TO NOTES THE APPROACH IT USED IN *LANDRETH* AND DETERMINE THAT THESE DEMAND NOTES ARE NOT SECURITIES

Alone among the enumerated terms in the 1934 Act's definition of a security, "note" is "a relatively broad term that encompasses instruments with widely varying characteristics." *Landreth*, 471 U.S. at 694. Some notes, such as publicly-offered and traded long-term corporate notes, are clearly securities and some, such as residential mortgage or consumer finance notes, are just as clearly not.[19] The status of other notes, however, has perplexed the lower federal courts as they

---

18 It is undeniable that an anomaly exists between "any note" being subject to the antifraud provisions of the 1933 Act, *see* 1933 Act, § 2(1), and only those with a maturity of more than nine months being subject to similar provisions of the 1934 Act. *See* 1934 Act, § 3(a)(10). It is neither the first nor the last such instance in federal statutes and, in fact, petitioners acknowledge there will be anomalies if their approach is adopted. *See* Pet. Br. at 33 n.40. If the anomaly is to be addressed, that is the role of Congress, not the courts.

19 NASAA, totally at odds with petitioners, the other amici and decades of case law, argues that virtually every note is a security. *See* NASAA Br. at 22-30.

have struggled for two decades to develop a meaningful test for determining which notes are securities.[20]

This Court has never considered a case specifically involving a note. It now has the opportunity to apply the approach it developed in *Landreth* to establish a much clearer, predictable and more objective means for deciding whether a particular note is a security than those flawed attempts of the lower courts.

A. *The Three Court of Appeals Tests for Notes*

Over time, the lower courts have developed three tests, each highly criticized and largely unsatisfactory, to determine what notes are securities. They are the "commercial/investment" test, *see, e.g., McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974); the "risk capital" test, *see, e.g. Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976); and the "family resemblance" test. *See, e.g., Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976).

1. *Commercial/Investment*

The commercial/investment test is the most widely used. Operating from the premise that a note is given for either an investment or a commercial purpose, it applies a long list of factors to the note transaction. If that exercise does not produce the conclusion that the note was part of a commercial transaction, it is held to be a security. *See, e.g., C.N.S.*

---

20 This struggle has been largely methodological. The various tests used, in fact, produce "virtually identical" results. *American Bank & Trust Co. v. Wallace*, 702 F.2d 93, 95 (6th Cir. 1983). *See also* Jones, *Footnote 11 of Marine Bank v. Weaver: Will Unconventional Certificates of Deposit Be Held Securities?*, 24 HOUS. L. REV. 491, 507-08 (1987).

Enterprises, Inc. v. G.&G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).

Professor Loss has criticized the "analytical imprecision" of the commercial/investment test. 2 L. Loss & J. Seligman, SECURITIES REGULATION 881 (3d ed. 1989). *Accord* Note, *Notes As Securities under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 MD. L. REV. 233, 243 & n.48 (1977) [hereinafter *Maryland Note*]. Even courts that have adopted the test complain that "[m]aking the distinction between commercial and investment notes when proceeds are to be used for a business purpose is often difficult." *Zabriskie v. Lewis*, 507 F.2d 546, 551 (10th Cir. 1974).

One commentator has concluded that "[t]he commercial-investment distinction is not helpful in adjudication and is liable to criticism as incoherent unless its proponents can explain it more satisfactorily than in the form of a laundry list." Fitzgibbon, *What Is a "Security": A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 MINN. L. REV. 839, 938 (1980) (footnotes omitted). *Accord Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d at 1136; *Williamson v. Tucker*, 645 F.2d 404, 427 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); Lizzul, *The Evolution of Bank Term Lending and the Status of Term Notes under the Federal Securities Laws*, 31 SYRACUSE L. REV. 959, 995 (1980); *Dillport, Restoring Balance to the Definition of Security*, 10 SEC. L.J. 99, 112 (1982).

The recent Tenth Circuit decision in *Holloway v. Peat, Marwick, Mitchell & Co.*, 879 F.2d 772 (10th Cir. 1989), exemplifies the difficulty courts have in applying the commercial/investment test. First, the court considered together instruments ranging from demand certificates to three-year term notes, even though they had different characteristics. Second, in purporting to apply *Zabriskie v. Lewis*, 507 F.2d

546 (10th Cir. 1974), it invoked some of the factors listed there and ignored others, such as the duration of the instrument and "whether the transaction is of a kind in which stock often actually is given." 507 F.2d at 551, quoting Comment, *Commercial Notes and Definition of "Security" under Securities Exchange Act of 1934: A Note Is a Note Is a Note?*, 52 NEB. L. REV. 478, 501 (1973) [hereinafter Nebraska Comment]. The *Holloway* decision, among its other flaws, simply demonstrates the unpredictability of the commercial/investment test.[21]

2. ***Risk Capital***

The Ninth Circuit has developed a variation of the commercial/investment test under the name "risk capital" test. It attempts, through a laundry list approach similar to that used in the commercial/investment test, to determine whether a note has been used to place investment capital at risk. *See, e.g., Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976). *See generally* Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. L. 1567, 1595-1601 (1980). Neither petitioners nor any of their amici advocate the risk capital test in this case.[22]

---

[21] In *Holloway* the "public offering" factor was a major determinant in the court's conclusion that the instruments were securities. Particularly where, as in *Holloway*, the very business of the institution was the sale of instruments to the public, that fact should have no bearing on the question whether the instruments it sold to the public were securities.

[22] The risk capital test has been criticized as "permit[ting] arbitrary interpretation and, hence, unpredictable results," Lizzul, 31 SYRACUSE L.REV. at 999, and as "lack[ing] predictive clarity and certainty because of its dependence on individualized fact situations." Glidden, *When Are Loans Security Transactions? A Proposed Test*, 13 SEC. REG. L.J. 212, 225 (1985). *Accord* 2 L. Loss & J. Seligman, SECURITIES REGULATION 887 (3d ed. 1989). In rejecting the "risk capital" approach, the Second Circuit concluded that "[d]irecting district courts to 'weigh' a number of such

3. ***Family Resemblance***

The Second Circuit's effort at formulating a test for what notes are securities -- the "family resemblance" test created in *Exchange National Bank* -- fares no better than the others. In that case Judge Friendly arbitrarily listed six examples of notes that he concluded were not securities and then ruled that, "[w]hen a note does not bear a strong family resemblance to these examples and has a maturity exceeding nine months, § 10(b) of the 1934 Act should generally be held to apply." *Exchange Nat'l Bank*, 544 F.2d at 1138.[23]

The family resemblance test illogically presumes that all ambiguous cases involve securities. *See* Sonnenschein, 35 BUS. L. at 1603. The Second Circuit has neither explained the presumption nor identified the determinative factors underlying the selection of the listed examples. This test, which has never been adopted outside the Second Circuit, has been criticized for providing "no predictable standard with which to determine the status of a note." Lizzul, 31 SYRACUSE L. REV. at 1001. As another commentator has concluded:

> It thus is clear that the [family resemblance] test, like the commercial-investment test, involves a range of factors -- in fact, many of the same ones.

---

dubious factors, without any instruction as to relative weights . . . is scarcely helpful to hard-pressed judges or to counsel." *Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d at 1137.

[23] The list of examples includes "the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalized an open-account debt incurred in the ordinary course of business." 544 F.2d at 1138. As one of the amici points out, Judge Friendly "did not explain or cite any authority indicating that Congress intended to exclude those items." NASAA Br. at 16.

> Both tests lack the theoretical grounding necessary to determine what factors should be relevant and how their importance should be assessed.

Fitzgibbon, 64 MINN. L. REV. at 940 (footnote omitted).[24]

This test has been applied by the district courts in the Second Circuit "as if the list [of six examples in *Exchange National Bank*] were exhaustive and definitive." Ahlburg, *The Status of Note Participations under the Federal Securities Acts*, 8 HARV. J.L. & PUB. POL'Y 465, 477 (1985). *Accord* Glidden, *When Are Loans Security Transactions? A Proposed Test*, 13 SEC. L.J. 212, 227 (1985). *See, e.g., Commercial Discount Corp. v. Lincoln First Commercial Corp.*, 445 F. Supp. 1263 (S.D.N.Y. 1978); *SEC v. Garfinkle*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,465 (S.D.N.Y. June 9, 1978).

In one case, *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir. 1984), Judge Friendly, writing for the Second Circuit, reversed a lower court determination that the notes at issue were securities because they "did not bear a strong family resemblance to the examples delineated by Judge Friendly." 552 F. Supp. 439, 448 (S.D.N.Y. 1982). Judge Friendly simply added a seventh example to his list -- notes evidencing loans by commercial banks for current operations -- to cover the case before the court. 726 F.2d at 939.[25]

---

[24] That the test is difficult to work with is apparent when an experienced securities law professor, writing on behalf of the state securities administrators in support of the test totally misstates it. *See* NASAA Br. at 17 (promissory notes are securities "unless the defendant can establish that the notes at issue do not bear a strong family resemblance to those covered by the securities act.").

[25] Although the district courts in the Second Circuit have limited the test to those instruments identified by Judge Friendly, the lack of any explanation in the test as to how these instruments were selected creates the possibility that a judge may add or subtract instruments at whim. That would remove from the test even the minimal predictive quality envisioned by Judge Friendly.

B. The *Landreth* Approach Applied to Notes

Rather than adopting any of the three discredited court of appeals tests, the Court should apply to notes the approach it developed in *Landreth*.

1. *Introduction*

Prior to 1985, virtually all of the what-is-a-security cases to reach the Court "involved unusual instruments not easily characterized as 'securities.'" *Landreth*, 471 U.S. at 690.[26] In almost every instance the Court decided whether those unusual instruments were securities by applying the test it had devised in *Howey*: "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." 328 U.S. at 301. *Landreth* reaffirmed *Howey*'s status as *the* method of analysis for "unusual instruments not easily characterized as 'securities.'" 471 U.S. at 690.

---

[26] *See, e.g., SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) (oil and gas leasehold interests); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (interests in citrus groves); *Tcherepnin v. Knight*, 389 U.S. 332 (1967) (withdrawable capital shares in a savings and loan association); *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975) (shares in a cooperative housing project); *Teamsters v. Daniel*, 439 U.S. 551 (1979) (pension interests); *Marine Bank v. Weaver*, 455 U.S. 551 (1982) (certificates of deposit and a privately negotiated profit-sharing agreement). The SEC tries to paint *Tcherepnin*, which involved *stock* in a savings and loan association, as dispositive of the securities law status of a savings account in such an institution and, by analogy, of demand notes. *See* SEC Br. at 26. The SEC does not explain why there is any similarity between shares of stock in a financial institution and the funds that an account holder may have on deposit in that institution.

Much of the Court's analysis in *Landreth* was foreshadowed a decade earlier in *Forman*. In that case the Court considered an instrument that had the label "stock" but none of the traditional characteristics of stock. It said:

> There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

421 U.S. at 850-51. Because the housing cooperative stock before it did not have these "significant characteristics," the Court turned to *Howey* as "the basic test for distinguishing the transaction from other commercial dealings." *Id.* at 852.

2. *The Landreth Decision*

In *Landreth* the Court resolved that traditional stock in a business corporation is a security, concluding that such "an instrument is covered [by the definition of "security"] when its characteristics bear out the label." 471 U.S. at 691.

The Court noted that the definition of "security" is divided into "instruments whose names alone carry well-settled meaning" and "instruments of 'more variable character [that] were necessarily designated by more descriptive terms.'" 471 U.S. at 686, quoting *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943). It held that the status of traditional stock as a security could be determined from the fact that it is "is both called 'stock' *and* bears stock's usual characteristics." 471 U.S. at 686 (emphasis added).

The Court explained that traditional stock, "the paradigm of a security," *id.* at 693, quoting *Daily v. Morgan*, 701 F.2d 496, 500 (5th Cir. 1983), is "relatively easy to

identify because it lends itself to consistent definition," 471 U.S. at 693, and "is more susceptible of a plain meaning approach" than "some instruments." *Id.* It concluded that the status under the securities laws of instruments "of more variable character" -- primarily investment contracts -- should be determined under *Howey*. *Landreth*, 471 U.S. at 689.

The Court deferred to another day -- which dawns in this case -- "the question whether 'notes' or 'bonds' or some other category of instrument listed in the definition might be shown 'by proving [only] the document itself.'" 471 U.S. at 694, quoting *Joiner*, 320 U.S. at 355.

3. The Extension of the *Landreth* Approach to Other Enumerated Securities

What the Court said about stock is, in large measure, true of other statutorily enumerated items. For example, there has been virtually no litigation as to whether bonds and debentures are securities. That must be, in part, because there is so little variation among them that they, like traditional stock, are "susceptible of a plain meaning approach" and of "consistent definition."

The courts of appeals have, in fact, begun to follow the *Forman/Landreth* approach with respect to enumerated items other than stock. That was certainly the approach of the Eighth Circuit to the demand notes before it in this case and *Landreth* has been used in a variety of settings by the Third, Fifth, D.C. and Seventh Circuits.

Penturelli v. Spector, Cohen, Gadon & Rosen, 779 F.2d 160 (3d Cir. 1985), involved fractional undivided interests in mineral rights, a specifically enumerated item in the definition of a security in section 3(a)(10). The Third Circuit recognized that *Landreth* had reserved questions beyond traditional stock, but it concluded that "much of the reasoning used by the Court is equally applicable to the case before us."

779 F.2d at 164. It said that, "if any inquiry other than whether the instrument fits the statutory definition is appropriate, it would be whether the instrument and transaction fit the traditional characteristics of the defined term." *Id.* at 167. Thus, following *Landreth*, the court held that, because the fractional undivided interests had the name and characteristics of the defined term, they were securities.

In *Adena Exploration, Inc. v. Sylvan*, 860 F.2d 1242 (5th Cir. 1988), which also involved fractional undivided interests in mineral rights, the court followed the same approach as *Penturelli*. As Judge Higgenbotham said, "[u]nder the *Landreth* inquiry, we must look to whether an instrument or transaction is covered by the plain language of the definition -- whether it 'lends itself to consistent definition' and is 'provable by its characteristics.'" 860 F.2d at 1249, quoting *Landreth*, 471 U.S. at 693.

The D.C. Circuit engaged in a similar analysis in evaluating an option to purchase stock in *One-O-One Enterprises, Inc. v. Caruso*, 848 F.2d 1283 (D.C. Cir. 1988). Aware of *Landreth's* reservation of other issues beyond the traditional stock before it in that case, the court of appeals said: "Nevertheless, *Landreth* heavily emphasizes a differentiation of traditional from non-traditional 'securities' instruments." 848 F.2d at 1288. Noting that the right to purchase a security, including stock, was enumerated in the 1934 Act definition, the court, relying on *Penturelli*, ruled that the option at issue "is such a traditional securities instrument that its existence may be shown 'by proving the document itself' without any need 'to look beyond the characteristics of the instruments' and, specifically, without any need to apply the *Howey* test." *Id.*

Finally, the Seventh Circuit recently demonstrated the value of starting with the *Landreth* analysis even when evaluating a non-traditional instrument. In *Secon Serv. Sys., Inc. v. St. Joseph Bank & Trust Co.*, 855 F.2d 406 (7th Cir. 1988), the court faced the question whether the sale of certain Interstate Commerce Commission operating authorities was the sale of a security. Judge Easterbrook concluded that, because the operating authorities had neither the name nor the characteristics of an enumerated security, the *Howey* test should be applied. He held that, because they failed that test, the operating authorities were not securities. 855 F.2d at 411.

These cases demonstrate that the *Landreth* approach can be effectively extended to enumerated items other than stock. The use of the *Landreth* analysis of characteristics for all enumerated instruments and *Howey* for unusual instruments such as investment contracts and for those enumerated instruments without the requisite characteristics, such as the stock in *Forman* and the notes in this case, brings into one framework all questions of what instruments are securities. This approach provides clear, objective standards and makes the results more predictive, not only for the courts, but also for those who must plan transactions. It not only brings to bear more than 40 years of precedent developed under *Howey*, but it also avoids the presence of a third, and unnecessary, test just for notes, as petitioners and their amici advocate.

4. *Landreth, Howey* and Notes

If the *Landreth* approach is applied to notes, there must be a means to identify those characteristics distinguishing notes that are securities from those that are not without developing a laundry list as vague as that used in the prevailing court of appeals tests. Because many of the notes that are securities have the same characteristics as bonds and debentures, which are also enumerated items in the definition of "securities" and which are unquestionably securities, bonds and debentures provide an appropriate reference point.

Over the years there has been no controversy over whether bonds and debentures are securities. *See, e.g., Broad*

v. Rockwell Int'l Corp., 614 F.2d 418 (5th Cir. 1980) (debentures); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979) (corporate bonds); *Rochelle v. Marine Midland Grace Trust Co.*, 535 F.2d 523 (9th Cir. 1976) (debentures); *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967) (convertible debentures). They are usually long-term corporate debt obligations evidenced by elaborate documentation and secured either by specific pledged assets, in the case of bonds, or by the general credit of the corporate issuer, in the case of debentures. *See, e.g.*, 2 THE NEW PALGRAVE -- A DICTIONARY OF ECONOMICS 261 (1987); BARRON'S FINANCE & INVESTMENT HANDBOOK 188, 229 (2d ed. 1986); INVESTMENT & SECURITIES DICTIONARY 29, 76 (1986); G. Munn & F. Garcia, ENCYCLOPEDIA OF BANKING & FINANCE 241 (8th ed. 1983).

Bonds and debentures are usually negotiable, are often traded publicly and are always among those "instruments ordinarily and commonly considered to be securities in the commercial world." *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982). Where bonds and debentures are involved, it is likely that "an investor would believe he was covered by the federal securities laws." *Landreth*, 471 U.S. at 687.

Professor Loss has noted the similarity between capital notes on the one hand and bonds and debentures on the other and, in fact, has described them as interchangeable. *See* L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 166 (2d ed. 1988). Capital notes are securities because they have the same characteristics as other long-term instruments of indebtedness that are generally recognized as securities -- they are capital infusions into a business entity and they are represented by instruments that are negotiable and, in fact, often traded publicly.

Thus, under the *Landreth* approach, the characteristics of a note are compared with those of bonds and debentures. If

the characteristics are the same, the note is a security. If, however, it is not clearly a security as a result of that comparison, a second level of analysis based on *Howey* is used to make the ultimate determination whether the note is a security.[27] This combination provides a flexibility missing in the other tests. In contrast to the *Landreth* approach, those other tests employ only one level of analysis and, if it is not absolutely clear that the note is *not* a security, it is then presumed to be a security.

Under *Howey*, the consumer, personal use and clearly commercial notes, such as those in the *Exchange National Bank* list, will be quickly excluded because, like the demand notes here, they cannot be said to evidence investments. Similarly, the one-on-one bank loans that provided so much of the impetus for the commercial/investment test, *see, e.g., McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), will not be securities under *Howey* because there is no common enterprise.[28]

---

[27] The *Howey* test helps the courts decide whether "the economic reality underlying the transactions indicated that the instruments were actually of a type that falls within the usual concept of a security." *Landreth*, 471 U.S. at 690. It is effective in doing this because, "in shorthand form, [it] embodies the essential attributes that run through all of the Court's decisions defining a security." *Forman*, 421 U.S. at 852

[28] Petitioners twice misstate how *Landreth* and *Howey* would apply to notes. At one point they suggest that a five-year consumer finance note would be a security under *Landreth*. *See* Pet. Br. at 18. At another point they assert that a long-term publicly traded corporate bond would not be a security under *Howey*. *See* Pet. Br. at 22. The consumer finance note would not be a security; in the first stage of the analysis it does not have the characteristics of a bond or debenture and, in the second stage, it does not satisfy *Howey* because there is no investment made with an expectation of profit and the note does not evidence a common enterprise. The bond is unquestionably a security; it is never analyzed under *Howey* because its status as a security can be determined at the first stage of analysis given the

There may be occasions when unique notes require more detailed analysis but the Court has expressed the clear view that the *Howey* test is the vehicle best suited for evaluating "unusual instruments not easily characterized as securities," a description fully applicable to notes without the characteristics of traditional bonds and debentures. *Landreth*, 471 U.S. at 690. It is probable that many notes that do not have the same characteristics as a bond or debenture will also not satisfy *Howey*. That is consistent with the experience under the three tests today where many notes are held not to be securities. *See supra* note 12.

Petitioners argue that using *Howey* in this formulation is meaningless, citing lower court decisions that a debt instrument could never satisfy the expectation of profit element of *Howey*. Pet. Br. at 21-22. *See, e.g., Hunssinger v. Rockford Business Credit, Inc.*, 745 F.2d 484, 491 (7th Cir. 1984); *Union Planters Nat'l Bank v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1184-85 (6th Cir.), *cert. denied*, 454 U.S. 1124 (1981); *but see El Khadem v. Equity Sec. Corp.*, 494 F.2d 1224, 1229 (9th Cir.), *cert. denied*, 419 U.S. 900 (1974).[29]

Under the *Landreth* approach, however, the *Howey* test is applied *only* to those notes without characteristics comparable to bonds and debentures. Among the notes that might be evaluated under *Howey* are those that contain contingent earning provisions, may be convertible to other

---

fact that, like "traditional stock," "bond" carries a well-settled meaning and lends itself to consistent definition.

[29] Petitioners and their amici are in sharp disagreement over how a fixed rate of interest affects the application of the *Howey* test. Petitioners and the Arkansas Securities Commissioner argue that no debt instrument can be a security under *Howey*. *See* Pet. Br. at 22; Ark. Br. at 24-25. The SEC and NASAA argue the opposite. *See* SEC Br. at 28; NASAA Br. at 14.

instruments or have flexible rates based on an entity's profits or losses. Any of these may be securities. However, notes that do not have unusual interest terms and that pay a fixed rate of return should not satisfy *Howey* because their holders have neither capital appreciation nor participation in earnings.

5. The *Landreth* Approach Is Superior to the Family Resemblance Test

The SEC stresses the importance of fidelity to the statute: "[a]n important virtue of the family resemblance test is that it conforms most closely to the statutory language." SEC Br. at 16.[30] However, of the tests suggested in this case, the *Landreth* approach unquestionably adheres most closely to section 3(a)(10). It starts with the statutory language and focuses on the characteristics of the instruments enumerated there. The family resemblance test, by contrast, begins and ends its analysis outside the statute by focusing on the factual context of the transaction.

A transactional analysis is helpful at some point in the evaluation of an instrument's characteristics and it is essential for those items, like investment contracts, that have no independent meaning and must therefore be defined in their transactional context. Transactional context is not, however, the appropriate starting point. Rather, as the Court said in *SEC v. National Sec., Inc.*, 393 U.S. 453 (1969), the relevant inquiry is *statutory* context:

> Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws; both the 1933 and the 1934 Acts preface their lists of general definitions with the phrase "unless the context

---

[30] However, the SEC never explains why the same fidelity is not required in construing the nine-month exclusion.

> otherwise requires." We must, therefore address ourselves to the meaning of the words "purchase or sale" in the context of § 10(b). Whatever these or similar words may mean in the numerous other contexts in which they appear in the securities laws, only this one narrow question is presented here.

Id. at 466.

The transactional approach of the family resemblance test violates the principles of statutory construction set out in *National Securities*. It also is at odds with the analyses of other courts, *see, e.g., Adena Exploration, Inc. v. Sylvan*, 860 F.2d at 1250; *American Bankers Ass'n v. SEC*, 804 F.2d 739, 754 (D.C. Cir. 1986); *Ruefenacht v. O'Halloran*, 737 F.2d 320 (3d Cir. 1984), *aff'd sub nom. Gould v. Ruefenacht*, 471 U.S. 701 (1985), and the commentators. *See, e.g.*, Rosin, *Historical Perspective on the Definition of a Security*, 28 S. TEX. L. REV. 577, 587-89 (1987); Steinberg, *The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 504-05 (1987); Gudridge, *Legislation in Legal Imagination: Introductory Exercises*, 37 U. MIAMI L. REV. 493, 559 (1983). In fact, its failings have been well documented by one of the amici. *See* NASAA Br. at 17-22. The fact is that the family resemblance test does not have a statutory anchor while the *Landreth* framework is grounded in the language of the statute.

Further, while the *Landreth* approach is a positive, inclusive test focused on the characteristics of statutorily enumerated instruments like bonds and debentures that are unquestionably securities, the family resemblance test, by contrast, is nothing more than a definition by default. It identifies items that are not securities, although it establishes no criteria by which that is determined, and then declares that, if

an instrument does not bear a "family resemblance" to those identified items, it is, *ipso facto*, a security.

There are obvious dangers with the family resemblance approach. Courts, as have the districts judges within the Second Circuit, may apply the six or seven items rigidly, a process that causes all ambiguous instruments to be securities because they do not resemble the items on an arbitrary list. However, given the absence of any explanation of how these examples are chosen, a court could as easily add or subtract instruments from the list. That would produce the kind of laundry list for which the commercial/investment and risk capital tests have been criticized and create the uncertainty and lack of predictability that so concerned the Court in *Landreth*.[31]

C. The *Landreth* Approach Applied to the Demand Notes in This Case

The *Landreth* approach, as applied in this case, leads inexorably to the conclusion that the demand notes are not securities. These notes have none of the characteristics of bonds or debentures. They are demand, not long-term, instruments. They are evidenced by a stationery store form, not the carefully crafted document that usually supports a bond or debenture. They could not be traded. Further, there was not a fixed number or dollar amount of notes outstanding, unlike traditional securities, and the aggregate volume and value of the notes increased or decreased entirely at the collective option of the note holders.

---

[31] It should be noted that, although the SEC pays lip service to *Landreth* and purports to relate the family resemblance test to the criteria in *Landreth*, *see* SEC Br. at 16, 17, 23, the family resemblance test, as petitioners acknowledge, *see* Pet. Br. at 16, bears no relationship to *Landreth*.

The application of *Howey* is equally clear in excluding these demand notes from the definition of a "security." *Howey* requires, first, that there be an investment. The demand feature of the notes is the antithesis of an investment, reflecting as it does instant liquidity, very low risk and the absence of a term commitment that is the *sine qua non* of an investment.

Further, because these notes carried a fixed rate of return, they do not satisfy the *Howey* requirement that the investment carry with it an "expect[ation] of profits." The notes had no potential for capital appreciation; the note holders received, when they made demand, exactly the amount they had given the Co-Op plus interest fixed by the terms of the note. The Co-Op was obligated to pay that interest whether or not it had any earnings. By the same token, no matter how high the Co-Op's earnings were, the demand note holders could receive no more than the determined interest rate. Under these circumstances, the *Howey* requirements cannot be met and the demand notes cannot be securities under that test.

Finally, there is nothing in the record indicating that any demand note holder had any expectation that the notes were covered by the federal securities laws. *See Landreth*, 471 U.S. at 693. In fact, given the manner in which note holders made "deposits" and "withdrawals," *see supra* at 2, they were obviously using the demand notes, not as investments, but as "cash" accounts available on demand and earning interest.

Petitioners and their amici argue that the fact that there were a large number of note holders makes the demand notes securities. If an instrument is, in fact, a security, the number of holders is relevant to an inquiry under the 1933 Act whether the offering of the instrument should have been registered with the SEC. The number of holders, however, is not relevant to the threshold inquiry whether the instrument is a security. As noted above, the Court has ruled that the federal securities laws

are not intended to provide a broad federal remedy for all fraud. *See supra* at 21.

Were the Court to rule, as petitioners and their amici argue, that wide distribution of a written instrument is a determinant that the instrument is a security, it would "federalize" much fraud that today is properly outside the antifraud provisions of the federal securities laws.[32] Certainly here, where there was no solicitation of the general public and demand note transactions were limited to Co-Op members and a few others who had contact with the Co-Op, *see supra* note 1, the number of note holders should not be a factor in determining whether the demand notes are securities.

III.

UNDER ANY OF THE COURT OF APPEALS TESTS, THE DEMAND NOTES ARE NOT SECURITIES

Even if the Court adopts one of the three court of appeals tests, rather than the *Landreth* approach, it should find that these demand notes are not securities.

A. *Commercial/Investment*

There are many variations of the commercial/investment test but none of them should apply so rigidly that these demand notes would be securities. The court below ruled that there was a commercial, rather than investment, basis for the purchase of the demand notes and, beyond that, various

---

32 Had the Court applied this analysis in *Landreth*, it might have held the stock at issue there not to be a security because there was only one purchaser. Conversely, where an entity is in the business of dealing with the public, that fact should have no bearing on a determination whether what it sells is a security. *See supra* note 21.

elements of the test cannot be satisfied here because of the demand nature of these notes.

For example, in *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974), the court applied the following test: "whether the transaction is of the kind in which stock often actually *is* given." *Id.* at 551, quoting *Nebraska Comment*, 52 NEB. L. REV. at 501. Under that version of the commercial/investment test the demand notes would surely not be securities because stock is not given in instances where an instrument is payable on demand or where funds are frequently "deposited" and "withdrawn."

Even under the version of the commercial/ investment test advanced, alternatively, by petitioners, it is doubtful that demand notes would be held to be securities. The purpose of that test is to determine if an investment has been made. *C.N.S. Enterprises, Inc. v. G.&G. Enterprises, Inc.*, 508 F.2d 1354, 1359 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *see also Maryland Note*, 36 MD. L. REV. at 243 & n.46. The instant liquidity inherent in demand notes is totally foreign to the concept of "investment" and the author of the criteria used in that version of the commercial/investment test has emphasized that a demand feature in a note is an indication that it is not a security. *Nebraska Comment*, 52 NEB. L. REV. at 521-23.

B. *Risk Capital*

With its focus on the placing of capital at risk, the Ninth Circuit test is even less likely to result in demand notes being securities than the commercial/ investment test from which it was derived. Having the right to a return of one's funds on demand is the antithesis of placing one's capital at risk through the efforts of others. Moreover, the leading risk capital case has ruled that a demand note "is almost *ipso facto* not a

security." *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1257 (9th Cir. 1976).

C. *Family Resemblance*

The analysis of these demand notes under the family resemblance test is rather different from the analysis under the commercial/investment and risk capital tests. As the SEC has noted, *see* SEC Br. at 17, this test contains a presumption that any note of nine months' maturity or less is not a security and petitioners would have "the burden of showing that 'the context otherwise requires.'" *Exchange National Bank*, 544 F.2d at 1137-38, quoting 1934 Act § 3(a). Petitioners could not make that showing.[33]

Although a demand note does not closely resemble any of the Second Circuit's family resemblance examples, it is even further removed from capital notes that, by virtue of their similarity to bonds and debentures, are clearly securities. If the family resemblance test were to be at all meaningful, it would have to be expanded to include, among the examples of instruments that are not securities, passbook and deposit accounts. If that were done, the family resemblance of demand notes to those sorts of instruments is clear and, under that refinement of the family resemblance test, the demand notes would not be securities.

---

33 Petitioners argue that *SEC v. American Board of Trade, Inc.*, 751 F.2d 529 (2d Cir. 1984), rejects any presumption that a note with a maturity of nine months or less is not a security. *See* Pet. Br. at 23 n.25. Ernst & Young -- and, apparently, the SEC, *see* SEC Br. at 17 -- do not read *American Board of Trade* as altering that presumption as the Second Circuit stated it in *Exchange National Bank*. *See* 544 F.2d at 1137-38. Even if petitioners were correct in their reading of Second Circuit law, the Court should apply the presumption if it adopts the family resemblance test. Without the presumption, the exclusionary language in section 3(a)(10) of the 1934 Act would be virtually meaningless.

CONCLUSION

For the reasons stated above, the judgment of the court of appeals should be affirmed.

New York, New York
September 16, 1989

Respectfully submitted,

John Matson
(Counsel of Record)
Carl D. Liggio
Elizabeth B. Healy
Jacqueline B. Steele
277 Park Avenue
New York, NY 10172
(212) 407-2358

Kathryn A. Oberly
2000 Pennsylvania Ave., N.W.
Washington, D.C. 20006

Fred Lovitch
4705 Central Avenue
Kansas City, MO 64112

Attorneys for Respondent

REPLY

BRIEF

Supreme Court, U.S.
FILED
OCT 14 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-1480

In The

Supreme Court of the United States

October Term, 1989

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, As Representatives of a Class of Note Holders,

Petitioners,

v.

ERNST & YOUNG,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR THE PETITIONERS

Robert R. Cloar
Court Plaza, Suite 102
51 South 6th Street
Fort Smith, Arkansas 72901
(501) 783-1186

Gary M. Elden
John R. McCambridge*
Jay R. Hoffman
Gripto & Elden
20 South Clark Street
Chicago, Illinois 60603
(312) 704-7700

Attorneys for Petitioners

*Counsel of Record

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

TABLE OF CONTENTS

Page

TABLE OF CONTENTS i

TABLE OF AUTHORITIES iii

REPLY TO RESPONDENT'S STATEMENT OF THE CASE 1

ARGUMENT IN REPLY 5

I. THE 1934 ACT'S EXCLUSION FOR CERTAIN SHORT-TERM INSTRUMENTS APPLIES ONLY TO COMMERCIAL PAPER, AND NOT TO PUBLICLY-OFFERED INVESTMENT INSTRUMENTS SUCH AS THE CO-OP NOTES 5

A. The Exclusion In Section 3(a)(10) Applies Only To Commercial Paper 7

1. Section 3(a)(3) Of The 1933 Act Is An Exemption For Commercial Paper 7

2. The Exclusion In Section 3(a)(10) Of The 1934 Act Is Virtually Identical To Section 3(a)(3) Of The 1933 Act; Each Applies Only To Commercial Paper 8

3. In *Securities Industry Association*, This Court Recognized That Section 3(a)(10) Of The 1934 Act Exempts Commercial Paper 12

B. Arthur Young Ignores The 1934 Act's Overriding Purpose Of Protecting The Investing Public 14

II. ARTHUR YOUNG'S "BOND AND DEBENTURE" TEST SHOULD NOT BE ADOPTED 15

TABLE OF CONTENTS – Continued

Page

A. Arthur Young's Modification Of *Landreth* Would Read "Note" Out Of The 1934 Act... 15

B. The *Howey* Test Is Equally Inapplicable To Notes..... 16

III. THE FAMILY RESEMBLANCE TEST SHOULD BE ADOPTED; IT PROPERLY BEGINS ITS ANALYSIS WITH THE STATUTORY LANGUAGE AND THEN CONSIDERS THE ECONOMIC REALITIES OF THE TRANSACTION..... 17

CONCLUSION 19

TABLE OF AUTHORITIES

Page

CASES

Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd., 544 F.2d 1059 (10th Cir. 1976), *cert. denied*, 431 U.S. 965 (1977)..... 9

Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976) 11, 18

Gunter v. Hutcheson, 674 F.2d 862 (11th Cir.), *cert. denied*, 459 U.S. 826 (1982)..... 9

Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) 14, 15, 16, 18

Marine Bank v. Weaver, 455 U.S. 551 (1982) 18

Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972)..... 10

Securities Industry Ass'n v. Board of Governors of Federal Reserve System, 468 U.S. 137 (1984) 12, 13

SEC v. American Board of Trade, 751 F.2d 529 (2d Cir. 1984) 10, 18

SEC v. National Sec., Inc., 393 U.S. 453 (1969)..... 18

SEC v. Ralston Purina Co., 346 U.S. 119 (1953)..... 1

Tcheripnin v. Knight, 389 U.S. 332 (1967).....9, 14

United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975)..... 14

United States v. Ron Pair Enterprises, 109 S. Ct. 1026 (1989)..... 6

TABLE OF AUTHORITIES – Continued

Page

STATUTES

15 U.S.C. § 77c(a)(3) ..... *passim*

15 U.S.C. § 78c(a)(10) ..... *passim*

15 U.S.C. § 80a-2(38) 12

OTHER AUTHORITIES

N. Baxter, *The Commercial Paper Market* (1966) 7

R. Foulke, *The Commercial Paper Market* (1931) 7, 8

H.R. Rep. No. 2639, 76th Cong., 3d Sess. (1940) 12

Hicks, *Commercial Paper: An Exempted Security Under Section 3(a)(3) of the Securities Act of 1933*, 24 UCLA L. Rev. 227 (1976) 8

L. Loss & J. Seligman, *Securities Regulation* (3d ed. & Supp. 1989) 17, 18

Note, *The Commercial Paper Market and the Securities Acts*, 39 U. Chi. L. Rev. 362 (1972) 9

S. Rep. No. 1775, 76th Cong., 3d Sess. (1940) 12

REPLY TO RESPONDENT'S STATEMENT OF THE CASE

For twenty-five years, the Co-Op marketed unsecured, uninsured demand notes as investments to well over 23,000 people. Over 1600 purchasers of those notes are members of the Class. Arthur Young's inability to avoid these key facts is highlighted by its Statement of the Case. The entire Statement contains only two citations to the voluminous record (neither of which supports the factual proposition asserted by Arthur Young).

The Co-Op Demand Notes Were Widely Offered To The Public.

Arthur Young asserts that the Class members were not members of the public and that the Co-Op therefore did not engage in "a broad-scale solicitation of investments." (Resp. Br. 1-2 & n.1, 21-22.)[1] The record disproves Arthur Young's position.

First, the term "public" in a securities context generally means "non-insiders." *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125-27 (1953). Although some, but not all (JA 22), of the Class members were "farmers who sold crops through, and bought supplies from, the Co-Op [and who] knew the organization and its operations" (Resp. Br. 22), they were not insiders. Nor did their status as Co-Op

---

[1] Citations in this brief observe the format in footnote 2 of the Class' opening brief. In addition, citations to the Brief for the Petitioners are in the form "Pet. Br. ___." Citations to the Brief for the Respondents are in the form "Resp. Br. ___." Citations to the Brief for the Securities and Exchange Commission are in the form "SEC Br. ___."

members or patrons give them access to those financial records that would have disclosed the fraud.

Only Arthur Young knew that the Co-Op was insolvent; Arthur Young nevertheless took the public stance that the Co-Op had a positive net worth. (*See* CAJA 230-31, 238-39; Trans. XI:99-110, XII:107-13.) Arthur Young alone knew that this misrepresentation was based upon its deliberate assignment of a false value to the Co-Op's largest single asset, the gasohol plant. (*See* Trans. IX:226-27, X:97-99, XI:272-73.)

Second, the Co-Op actually did engage, for twenty-five years, in a broad-scale solicitation of investments. Every month, the Co-Op's 23,000 members, their families, and other local persons who read "Your Co-Op News" were urged to buy demand notes as "investments." (Pet. A70; *see* CAJA 1819-904.) This pool of investors comprised a significant portion of the local population. For example, the Co-Op's principal place of business was Van Buren, Arkansas (JA 22), a town of about 13,000. The Co-Op's smaller branch operations were in Muskogee, Sallisaw, and Stigler, Oklahoma, and Caulksville, Arkansas (*id.*), which have a combined population of under 60,000.

Third, membership in the Co-Op required nothing more than the payment of five dollars (JA 15); members were not required to purchase demand notes and most did not. All of the Co-Op's benefits were available to every member, without regard to whether the member had purchased notes.

The Demand Notes Were Sold As Investments.

The Class showed in its opening brief that the demand notes were marketed as investments in every

issue of "Your Co-Op News." (Pet. Br. 4; *see* JA 5; CAJA 1819-904.) The Co-Op's marketing efforts were successful. As their letters to the bankruptcy trustee demonstrate, many Class members viewed the notes as investments and held them for long periods of time. (*See, e.g.*, CAJA 1491, 1514, 1517, 1526, 1542, 1548, 1600.)

Arthur Young argues, without support, that the demand notes were really either loans or "passbook savings accounts available at savings and loan associations or commercial banks." (Resp. Br. 2, 8.) In fact, none of the Co-Op's solicitations ever described the purchase of demand notes as a loan to the Co-Op. (CAJA 1819-904.) The Eighth Circuit's belief that the over 1600 Class members were commercial lenders is completely contrary to the facts. Furthermore, even if the Co-Op note program had resembled a passbook savings account, the notes were not protected by the deposit insurance that banks and savings and loans typically offer. Finally, the Co-Op was not regulated by any banking or savings and loan authority and plainly was not a financial institution; the Co-Op was in the business of buying and selling farm products.

Arthur Young Properly Was Held Liable.

The sole issue before this Court is whether the Co-Op's demand notes are securities. Arthur Young seeks to cloud the issue by arguing that this is an ordinary accountant's liability case and that, even if the demand notes are securities, it has no liability. (*See* Resp. Br. 2-4.) Although Arthur Young's argument on this point is not properly made to this Court, the Class will reply briefly here.

Arthur Young did not function simply as an auditor or accountant for the Co-Op. Instead, it stepped into the role of management and unilaterally made critical decisions which enabled it to falsely represent the Co-Op as a solvent entity with a positive net worth. The most important of these decisions concerned the gasohol plant. If the Co-Op had always owned the plant, it ordinarily could have been carried on the financial statements at the actual cost of building it (Trans. XIV:188), which Arthur Young put at $4.5 million. (Trans. IX:177-86.) If the Co-Op had not always owned the plant, it would have to be carried at substantially less than $1 million. (Trans. IV:97-98, XIV:181.)

Arthur Young knew that the Co-Op actually had acquired the plant from Jack White.[2] Nevertheless, Arthur Young adopted the fiction that Jack White had never owned any part of the gasohol plant and that the Co-Op always had owned all of it. (Trans. IX:212, X:44-45.) Arthur Young did not consult with any director of the Co-Op prior to making this decision and did not later tell anyone of its decision. (Trans. IX:226-27, X:97-98, XI:272-73.) Arthur Young assigned a value of $4.5 million to the gasohol plant (Trans. IX:175-76), and then presented the Co-Op as having a positive net worth of $2.6 million at the end of 1981. (CAJA 230-31, 238-39; Trans. X:115, XI:99-110.) Had Arthur Young recognized the Co-Op's acquisition of the plant and handled the transaction properly, the Co-Op's net worth would have disappeared. (*See* CAJA 238-39; Trans. IV:97-98, XIV:185-88, 201-09.)

[2] Arthur Young stated in its own workpapers that the "Co-Op acquired White Flame" from Jack White. (CAJA 1234, 1239.) Documents reviewed by Arthur Young plainly showed that the gasohol plant had been owned first by a man named Ed Dooley, then by Dooley and White, then by White alone. (CAJA 1099-173; Trans. IX:212-27.) When the gasohol plant became a financial disaster (Trans. IX:223, X:29-33), White transferred it to the Co-Op in a "friendly lawsuit." (CAJA 923-31; Trans. IX:222-25.)

Arthur Young's false value for the gasohol plant and its accompanying false representation that the Co-Op had a positive net worth were of critical importance. First, Arthur Young's representation permitted the Co-Op to continue operating and to continue selling demand notes. Second, Arthur Young's false values for the gasohol plant and the Co-Op as a whole were included in the Co-Op's 1981 and 1982 financial statements (CAJA 238-39, 256-77), the Co-Op's condensed financial statements (JA 19; CAJA 230-33), and the financial reports presented orally by Arthur Young at each annual meeting. (Trans. XI:99-110, 149-52.)

ARGUMENT IN REPLY

I. THE 1934 ACT'S EXCLUSION FOR CERTAIN SHORT-TERM INSTRUMENTS APPLIES ONLY TO COMMERCIAL PAPER, AND NOT TO PUBLICLY-OFFERED INVESTMENT INSTRUMENTS SUCH AS THE CO-OP NOTES.

In its response, Arthur Young asks this Court to adopt a radical new view of section 3(a)(10) of the 1934 Act. According to Arthur Young, a note's status as a security depends exclusively on its maturity; notes with a maturity of nine months or less are never securities, while notes with a maturity greater than nine months are always securities. Arthur Young argues that the plain meaning of section 3(a)(10) compels this view.

Arthur Young is wrong. The language of the exclusion in section 3(a)(10) applies to commercial paper. The four-term phrase ("notes, drafts, bills of exchange, or banker's acceptances") used in that section describes the instruments used to evidence commercial paper. The maturity limit of nine months was the outside maturity limit for commercial paper in the 1930s. The Class' reading of the exclusion in section 3(a)(10) is consistent with the remedial purposes of the 1934 Act and the legislative history of the securities laws.[3]

In clear contrast, Arthur Young's "maturity" test gives effect to only a few words in the exclusion and ignores all of the other language in section 3(a)(10). The perverse results produced are contrary to both the primary purpose of the securities laws and many years of precedent. Arthur Young's test would deny the protections of the 1934 Act to members of the public who invest in widely-offered notes which mature within nine months or are payable on demand. Conversely, because section 3(a)(10) defines "security" to include "any note," Arthur Young's reading would extend the coverage of the 1934

---

[3] Arthur Young relies (Resp. Br. 13) on a quotation from *United States v. Ron Pair Enterprises*, 109 S. Ct. 1026, 1031 (1989), which states that a court will enforce plain statutory language according to its terms. *Ron Pair* does not support Arthur Young's position here. The word "note" must be read in the context of both the four-term phrase in which it appears and the remainder of the exclusion, which together plainly mean commercial paper. Arthur Young's reading improperly ignores much of the language of the exclusion. Even if Arthur Young's misreading were correct, *Ron Pair* also states that in those rare instances where a literal application of a statute could defeat the intention of the drafters, the intention of the drafters controls. 109 S. Ct. at 1031.

Act to the many notes given in two-party consumer and commercial transactions, so long as their maturities exceed nine months. (*See* Resp. Br. 8-9.)[4] Arthur Young's maturity test should be rejected.

A. The Exclusion In Section 3(a)(10) Applies Only To Commercial Paper.

1. Section 3(a)(3) Of The 1933 Act Is An Exemption For Commercial Paper.

The language of section 3(a)(3) of the 1933 Act can be understood properly only in context. The phrase "note, draft, bill of exchange, or banker's acceptance" in section 3(a)(3) describes the instruments which evidence commercial paper. Congress apparently borrowed this list from the Federal Reserve Act of 1913 and the Federal Reserve Board's Regulation A of 1920. (SEC Br. 20 & n.11.) Congress' selection of nine months as the maximum maturity for exempt commercial paper was not arbitrary; at the time, most commercial paper was used for seasonal borrowing and typically matured in nine months or less.[5]

---

[4] For example, under Arthur Young's approach, a two-year note issued in a one-on-one consumer financing transaction (such as the purchase of a television) would be a security subject to the provisions of the 1934 Act. Any material misrepresentation made in connection with its issuance (such as the consumer's misstated income) would create a federal securities claim.

[5] R. Foulke, *The Commercial Paper Market* 3 (1931) (commercial paper matures in two to nine months); *see also* N. Baxter, *The Commercial Paper Market* 29 (1966) (commercial paper available in maturities of 3 to 270 days). In fact, the Co-Op had seasonal borrowing needs. It met them by borrowing money each spring and fall from CFA, the financial arm of Farmland, a giant association of cooperatives. (Trans. III:62-64.)

The legislative history of section 3(a)(3) confirms that the exemption applies only to commercial paper. As Congress and the investment bankers who sought this exemption carefully explained, commercial paper was marketed to sophisticated professionals, and not to members of the public. (SEC Br. 19-22; Pet. Br. 33-36.)[6] In sum, section 3(a)(3) of the 1933 Act exempts from registration those short-term instruments which evidence commercial paper.

2. The Exclusion In Section 3(a)(10) Of The 1934 Act Is Virtually Identical To Section 3(a)(3) Of The 1933 Act; Each Applies Only To Commercial Paper.

Section 3(a)(10) of the 1934 Act excludes from the definition of security "note[s], draft[s], bill[s] of exchange, or banker's acceptance[s]" with maturities of nine months or less. This exclusion is, with one exception, identical to the exemption in section 3(a)(3) of the 1933 Act.

---

[6] In the 1930s, commercial paper generally was issued by a business to a bank. Commercial paper was credit-rated and of low risk. R. Foulke, *supra* note 5, at 65-80, 96-98, 256. As one commentator explained:

> [T]he commercial paper exemption under section 3(a)(3) exists because Congress believed that such securities were safe, both because they were virtually riskless and because they were generally unavailable to the average, unsophisticated investor; registration of commercial paper would be harmful to business; and the Federal Reserve Board could adequately regulate such short-term instruments.

Hicks, *Commercial Paper: An Exempted Security Under Section 3(a)(3) of the Securities Act of 1933*, 24 UCLA L. Rev. 227, 284 (1976).

Both the exclusion and the exemption therefore apply only to commercial paper.

The similarity between the two provisions also means, contrary to Arthur Young's position, that there is legislative history that is relevant to section 3(a)(10). The applicability of the legislative history of section 3(a)(3) is confirmed by the fact that section 3(a)(10) was included in a companion securities act passed by the same Congress only fifty-four weeks later.

This Court has used prior decisions interpreting the meaning of "security" under the 1933 Act to understand the corresponding provision in the 1934 Act. *Tcheripnin v. Knight*, 389 U.S. 332, 335-36 (1967). Courts have construed the two laws in pari materia as parts of a single, comprehensive federal regulatory scheme.[7] The two Acts' virtually identical exclusions for certain short-term instruments should therefore be interpreted in the same manner:

> The construction of the exclusionary provision of section 3(a)(10) of the 1934 Act in terms of the legislative history of the section 3(a)(3) exemption of the 1933 Act is particularly proper in this instance because of the companion scope and aims of the two federal securities acts and because of the absence in the legislative history of an explanation for the exclusionary language of section 3(a)(10).

Note, *The Commercial Paper Market and the Securities Acts*, 39 U. Chi. L. Rev. 362, 400 (1972) (footnote omitted);

---

[7] *E.g., Gunter v. Hutcheson*, 674 F.2d 862, 876 (11th Cir.), *cert. denied*, 459 U.S. 826 (1982) (collecting cases). Because the two Acts' definitions of "security" are virtually identical and cover similar interests, they are considered coextensive. *Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd.*, 544 F.2d 1059, 1066 (10th Cir. 1976), *cert. denied*, 431 U.S. 965 (1977).

accord SEC v. American Board of Trade, 751 F.2d 529, 538-39 (2d Cir. 1984); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1078-80 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972).

Arthur Young's reliance on the absence of a detailed legislative history of section 3(a)(10) is not persuasive. One would expect to find testimony, comments, debate, or analysis concerning this provision only if Congress intended it to have a different meaning than section 3(a)(3). Arthur Young admits, as it must, that the language of the exclusion in section 3(a)(10) tracks almost exactly the terms of section 3(a)(3). In both 1933 and 1934, Congress used the same four-term phrase ("note, draft, bill of exchange, or banker's acceptance") and the same nine month maturity limit.

Arthur Young's efforts to distinguish between the two exemptions are unavailing. Arthur Young first argues that the two provisions are unrelated because their locations are not identical. Section 3(a)(3) exempts certain notes from the 1933 Act's registration provision, while the exclusion in section 3(a)(10) exempts certain notes from all of the 1934 Act's provisions. Arthur Young cannot explain why the varying locations of these exceptions within the framework of the Acts should cause them to have disparate meanings. The difference in locations probably is due to the fact that the 1934 Act, as originally enacted, had no provision analogous to section 3 of the 1933 Act (exempting a number of classes of securities from the registration requirements).[8]

---

[8] As Judge Friendly explained,

> When the 1934 Act was passed there was no need for a special exemption of notes from registration, since the registration requirement was tied to

(Continued on following page)

Arthur Young also notes that there is one textual difference between the language of section 3(a)(3) and the exclusion in section 3(a)(10): the latter does not include the "current transactions" phrase used in the previous year's provision. Arthur Young claims that the omission of the "current transactions" phrase from section 3(a)(10) "can only mean" that Congress intended to create a "broader and differently focused" exclusion. (Resp. Br. 18.) Given the purpose of the 1934 Act and the absence of congressional comment on the deletion of the "current transactions" phrase, it is much more likely that Congress decided it could (or should) define commercial paper without using this phrase.

This last conclusion is supported by the fact that six years later, in the Investment Company Act of 1940 ("the 1940 Act"), Congress again defined commercial paper without including section 3(a)(3)'s "current transactions" phrase:

> "Short-term paper" means any note, draft, bill of exchange, or banker's acceptance payable on demand or having a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof payable on demand or having a maturity likewise limited; and such other classes of securities, of a commercial rather than an investment

---

(Continued from previous page)

> transactions on a national stock exchange, § 12(a). If notes were to have special treatment beyond this, the place to accord this had therefore to be in the definition of a security. This situation was altered by the addition of § 12(g) in 1964 . . . .

Exchange Nat'l Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1132 & n.9 (2d Cir. 1976).

> character, as the Commission may designate by rules and regulations.

15 U.S.C. § 80a-2(38).

Furthermore, the 1940 Act incorporates the terms common to both section 3(a)(3) and the exclusion in section 3(a)(10): it uses the phrase "note, draft, bill of exchange, or banker's acceptance" to describe the instruments that evidence commercial paper, and employs the nine month maturity limit for exempt commercial paper. The 1940 Act, unlike the 1933 and 1934 Acts, also empowered the SEC to exempt "*other* classes of securities, of a commercial rather than investment character."[9]

3. In *Securities Industry Association*, This Court Recognized That Section 3(a)(10) Of The 1934 Act Exempts Commercial Paper.

This Court already has considered favorably, albeit in dictum, the long-standing interpretation of the exemption in section 3(a)(10) that Arthur Young now seeks to reverse. *See Securities Industry Association v. Board of Governors of Federal Reserve System*, 468 U.S. 137, 150-51 & n.7 (1984) (dictum). *Securities Industry Association* involved a provision of the Banking Act of 1933 (better known as the Glass-Steagall Act), which generally prohibits commercial banks from marketing notes or other securities. The Court held that the terms "notes" and "securities," as

[9] There is no legislative history of this provision in the 1940 Act. *See* S. Rep. No. 1775, 76th Cong., 3d Sess. 12 (1940); H.R. Rep. No. 2639, 76th Cong., 3d Sess. 11 (1940). Like the 1934 deletion of the "current transactions" phrase, Congress apparently did not find its 1940 revision to the definition of commercial paper – the grant of authority to the SEC to exempt additional commercial securities – to be a significant enough change to merit discussion.

used in the Glass-Steagall Act, include commercial paper. 468 U.S. at 149-50.

To reach this result, the Court compared the disputed provision in the Glass-Steagall Act to the relevant provisions in the 1933 Act and the 1934 Act because the three acts were "collectively designed to restore public confidence in financial markets." 468 U.S. at 150. The Court found that the Glass-Steagall Act was the only one that did not expressly exempt commercial paper from the definition of "security":

> In each of these other statutes, the definition of the term "security" includes commercial paper, and each statute contains explicit exceptions where Congress meant for the provisions of an Act not to apply to commercial paper. See 15 U.S.C. § 77c(a)(3) (exempting certain "note[s]" with maturities of less than nine months from the definition of "security" for certain provisions of the Securities Act of 1933); 15 U.S.C. § 78c(a)(10) (exempting certain "note[s]" with maturities of less than nine months from the definition of "security" under the Securities Exchange Act of 1934) . . . .

468 U.S. at 150-51 & n.7.

Thus, the Court identified section 3(a)(10) as containing the "explicit exception[]" for commercial paper in the 1934 Act. The Court also recognized that the exemption applies only to "*certain* 'note[s]' with maturities of less than nine months," not to all short-term notes. Arthur Young's contention that *Securities Industry Association* somehow supports its position (Resp. Br. 18-19 & n.11) is completely without basis.

B. Arthur Young Ignores The 1934 Act's Overriding Purpose Of Protecting The Investing Public.

Arthur Young never even mentions Congress' purpose in enacting the securities laws. It thereby implicitly insists that the purpose of the Acts is irrelevant to section 3(a)(10). This Court's decisions construing the federal securities laws prove that Arthur Young's approach is mistaken.

In *Tcheripnin v. Knight*, 389 U.S. 332 (1967), for example, the Court held that the definition of "security" in the 1934 Act must be construed broadly in order to meet Congress' remedial aim of protecting the investing public:

> [W]e are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation. One of its central purposes is to protect investors through the requirement of full disclosure by issuers of securities, and the definition of security in § 3(a)(10) necessarily determines the classes of investments and investors which will receive the Act's protections.

Id. at 336 (footnote omitted); *accord Landreth Timber Co. v. Landreth*, 471 U.S. 681, 687 (1985). " '[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality.' " *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 848 (1975), *quoting Tcheripnin*, 389 U.S. at 336.

Arthur Young's reading of section 3(a)(10) has as its only purpose the removal of the Co-Op notes from the 1934 Act's coverage. But Arthur Young's reading would elevate form over substance and thwart Congress' desire

to protect investors. The Co-Op marketed its notes as investments and sold them to thousands of ordinary people for nearly $10 million. The Class members are within the group of persons that Congress, through the federal securities laws, intended to protect.

II. ARTHUR YOUNG'S "BOND AND DEBENTURE" TEST SHOULD NOT BE ADOPTED.

In the first section of its response, Arthur Young argues that the status of a note depends solely on its maturity: notes which mature in more than nine months are securities, while other notes are not. As the Class already has demonstrated, this view is not tenable.

In the second section of its response, Arthur Young abandons its "maturity" test. Arthur Young presents instead an alternative and contradictory test, which concludes that notes of any maturity can be securities only if they are really bonds or debentures. Arthur Young's new two-step test should be rejected because it has no basis in the statute, in precedent, or in logic.

A. Arthur Young's Modification Of *Landreth* Would Read "Note" Out Of The 1934 Act.

Arthur Young's bond and debenture test has two steps. The first draws on *Landreth*, which Arthur Young now interprets differently than it did in the Eighth Circuit. Under Arthur Young's current version, a "note" is a "security" only if it has the same characteristics as "bonds" and "debentures." (Resp. Br. 34-35.) Notes, bonds, and debentures all are instruments specifically enumerated in section 3(a)(10).

Arthur Young's new test should not be adopted; it provides that an instrument specifically enumerated in

section 3(a)(10) (*e.g.*, a "note") can be a security only if it possesses the characteristics of another enumerated instrument (*e.g.*, a "bond" or "debenture"). In *Landreth*, the Court concluded that the *Howey* test for "investment contracts" should not be applied to "stock" and other listed instruments, reasoning that to do so "would make the Acts' enumeration of many types of instruments superfluous." *Landreth*, 471 U.S. at 692 (citations omitted). Similarly, the enumeration of "note" in section 3(a)(10) would be made superfluous by Arthur Young's new test.

B. The *Howey* Test Is Equally Inapplicable To Notes.

Arthur Young proposes to add a second step to its modified *Landreth* test, apparently conceding that notes that are neither bonds nor debentures might still be securities. Arthur Young urges that notes that fail step one should be examined under the *Howey* "investment contract" test. Applying the *Howey* analysis to notes, however, is pointless. All notes fail Arthur Young's version of *Howey*, which holds that an instrument cannot be a security unless it carries the expectation of "profit"; according to Arthur Young, interest can never be "profit." (Resp. Br. 40.) Notes by definition pay interest, and step two therefore is meaningless.[10]

---

[10] Professors Loss and Seligman describe the decision below as "a particularly tortured application of the *Howey* test to a demand note," explaining that:

> It simply makes little sense to analyze whether a note is a security by considering whether, as in

(Continued on following page)

III. THE FAMILY RESEMBLANCE TEST SHOULD BE ADOPTED; IT PROPERLY BEGINS ITS ANALYSIS WITH THE STATUTORY LANGUAGE AND THEN CONSIDERS THE ECONOMIC REALITIES OF THE TRANSACTION.

Arthur Young's principal criticism of the family resemblance test that the Class and amici prefer is its purported disregard of the language of section 3(a)(10). On the contrary, of all the note tests, the family resemblance test is truest to the statutory language.

Section 3(a)(10) defines "security" to include "any note" but excludes commercial paper. The family resemblance test advanced by the Class therefore recognizes that commercial paper notes are not securities and presumes that all other notes are securities.[11] The test also recognizes that the presumption should be overcome where the note is issued in a context which strongly resembles those transactions that the 1933 and 1934 Acts plainly do not cover. Thus, the family resemblance test narrows the broad scope of the Acts' definition of "security" in accordance with the purposes of the Acts.

(Continued from previous page)

> *Howey*, there was a "reasonable expectation of profits." That is a test of relevance solely to equity, not debt. Moreover it is troublesome that this court ignored the fact that an offer was made here to a co-op's entire membership, approximately 350 [actually, over 1600] of whom purchased the notes.

L. Loss & J. Seligman, *Securities Regulation* 56 (Supp. 1989).

[11] Because section 3(a)(10)'s exemption for short-term notes applies only to commercial paper, the nine month maturity limit is irrelevant for other short-term notes. Thus, the presumption that all notes are securities should not depend on

(Continued on following page)

The family resemblance test is consistent with prior statements of this Court. The *Landreth* Court, in holding that all stocks are securities, described the transaction at issue there to be "typical of the kind of context to which the Acts normally apply." 471 U.S. at 687. In *Marine Bank v. Weaver*, 455 U.S. 551 (1982), the Court stated:

> The definition of "security" in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires.
>
> * * *
>
> Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

Id. at 558-59, 560 n.11 (context dictating that instruments protected by federal deposit insurance were not securities). Professors Loss and Seligman take a similar view:

> It is difficult to imagine . . . a court's determining whether a particular note was a statutory security without examining the context of the transaction.

L. Loss & J. Seligman, 2 *Securities Regulation* 874 (3d ed. 1989) (footnote omitted).[12]

(Continued from previous page)

maturity. If the Class is incorrect that *American Board of Trade* removed the nine month maturity factor from the Second Circuit test (as originally articulated in *Exchange Nat'l Bank*) (*see* Pet. Br. 23 n.25), the Class urges this Court to adopt the family resemblance test as stated by the Class. Even assuming that the Co-Op notes are presumed not to be securities, the evidence that those notes are investments within the scope of the 1934 Act is overwhelming and would rebut any negative presumption.

[12] Arthur Young cites *SEC v. National Sec., Inc.*, 393 U.S. 453 (1969), as support for its position that context is irrelevant.

(Continued on following page)

CONCLUSION

The heart of this dispute is captured in Arthur Young's remarkable assertions that neither the public nature of an offering nor the number of purchasers should have any bearing on whether particular notes are securities. (Resp. Br. 26 n.21, 40.) The Class disagrees vehemently. The broad, public nature of the Co-Op's offering and its marketing of the notes as "investments" are the most relevant facts in the case. In giving life to section 3(a)(10), one must bear in mind that Congress enacted the federal securities laws to protect ordinary people from widespread fraudulent offerings of investments. Contrary to the views of the Eighth Circuit and Arthur Young, the Class is not composed of 1600 commercial lenders. The members of the Class are 1600 individuals who were solicited to purchase uninsured and uncollateralized notes as investments and did so, investing nearly $10 million. The instruments they bought are securities. The Eighth Circuit used the wrong analysis and reached a manifestly incorrect and unjust result. Its

---

(Continued from previous page)

(Resp. Br. 37-38.) The Court in that case, after finding two terms ("purchase" and "sale") in the definitional section of the 1934 Act "unhelpful," looked to the context of the transaction to determine whether the 1934 Act should be applied to the alleged conduct. 393 U.S. at 466-67.

decision should be reversed, and this case should be remanded for further proceedings.

Respectfully submitted,

GARY M. ELDEN
JOHN R. MCCAMBRIDGE*
JAY R. HOFFMAN
GRIPPO & ELDEN
20 South Clark Street
Chicago, Illinois 60603
(312) 704-7700

ROBERT R. CLOAR
Court Plaza, Suite 102
51 South 6th Street
Fort Smith, Arkansas 72901
(501) 783-1186

Attorneys for Petitioners

*Counsel of Record

AMICUS CURIAE

BRIEF

Supreme Court, U.S.
FILED
JUL 27 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-1480

In the Supreme Court of the United States

OCTOBER TERM, 1989

BOB REVES, ET AL., PETITIONERS

v.

ARTHUR YOUNG & CO.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE SUPPORTING PETITIONERS

KENNETH W. STARR
Solicitor General
THOMAS W. MERRILL
Deputy Solicitor General
MICHAEL R. LAZERWITZ
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

DANIEL L. GOELZER
General Counsel
PAUL GONSON
Solicitor
JACOB H. STILLMAN
Associate General Counsel
MARTHA H. MCNEELY
Special Counsel
RANDALL W. QUINN
EVA MARIE CARNEY
Attorneys
Securities and Exchange Commission
Washington, D.C. 20549

39

QUESTION PRESENTED

Whether interest-bearing promissory notes, payable on demand, that are widely sold by a farmers cooperative association to its members and others as investments, are securities under the federal securities laws.

TABLE OF CONTENTS

	Page
Interest of the Securities and Exchange Commission	1
Statement	2
Summary of argument	7
Argument:	
Interest-bearing promissory notes, payable on demand, that are widely offered and sold to the public as investments, are securities under the federal securities laws	10
I. A note is a security within the statutory definition, unless it resembles certain types of notes not used for investment purposes that are clearly outside the scope of the federal securities laws	10
II. The Co-Op's interest-bearing, demand promissory notes are securities within the statutory definition, since they do not resemble those categories of notes used for commercial purposes that are clearly outside the scope of the federal securities laws	23
III. The Co-Op's notes need not satisfy the "investment contract" test to qualify as securities since they are "notes" within the statutory definition of security	27
Conclusion	30

TABLE OF AUTHORITIES

Cases:

American Bank & Trust v. *Wallace*, 702 F.2d 93 (6th Cir. 1983)	13
Baurer v. *Planning Group, Inc.*, 669 F.2d 770 (D.C. Cir. 1981)	8, 15, 21
Bellah v. *First Nat'l Bank*, 495 F.2d 1109 (5th Cir. 1974)	13
Blonder-Tongue Laboratories, Inc. v. *University of Illinois Found.*, 402 U.S. 313 (1971)	16
Briggs v. *Sterner*, 529 F. Supp. 1155 (S.D. Iowa 1981)	25
C.N.S. Enterprises, Inc. v. *G & G Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), cert. denied, 423 U.S. 825 (1975)	13

Cases—Continued: Page

Carlson v. *Green*, 446 U.S. 14 (1980) 16
Chemical Bank v. *Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), cert. denied, 469 U.S. 884 (1984) 14, 17, 23, 24
Daily v. *Morgan*, 701 F.2d 496 (5th Cir. 1983) 16
El Khadem v. *Equity Securities Corp.*, 494 F.2d 1224 (9th Cir.), cert. denied, 419 U.S. 900 (1974) 29
Exchange Nat'l Bank v. *Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976) 13, 14, 17, 22, 23, 24
Futura Development Corp. v. *Centex Corp.*, 761 F.2d 33 (1st Cir.), cert. denied, 474 U.S. 850 (1985) 12-13
Gary Plastic Packaging Corp. v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985) 29
Great Western Bank & Trust v. *Kotz*, 532 F.2d 1252 (9th Cir. 1976) 4, 6, 13, 14, 25
Holloway v. *Peat, Marwick, Mitchell & Co.*, No. 87-1486 (10th Cir. July 11, 1989) 15, 25
Hunssinger v. *Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984) 10, 27
Kansas State Bank v. *Citizens Bank*, 737 F.2d 1490 (8th Cir. 1984) 28
Landreth Timber Co. v. *Landreth*, 471 U.S. 681 (1985) .. 6, 8, 10, 11, 12, 16, 23
Lawler v. *Gilliam*, 569 F.2d 1283 (4th Cir. 1978) 11, 27
Lino v. *City Investing Co.*, 487 F.2d 689 (3d Cir. 1973) ... 13
Marine Bank v. *Weaver*, 455 U.S. 551 (1982) 26
McClure v. *First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975) 11, 21, 27
People v. *White*, 124 Cal. App. 548, 12 P.2d 1078 (Dist. Ct. App. 1932) 28
Sanders v. *John Nuveen & Co.*, 463 F.2d 1075 (7th Cir.), cert. denied, 409 U.S. 1009 (1972) 15
SEC v. *American Bd. of Trade*, 751 F.2d 529 (2d Cir. 1984) 10, 15, 17, 21, 27
SEC v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) .. 11, 12, 29
SEC v. *Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974) 9, 25

Cases—Continued: Page

SEC v. *United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) 26, 29
SEC v. *W.J. Howey Co.*, 328 U.S. 293 (1946) 6, 10, 27, 28, 29
SEC v. *World Radio Mission*, 544 F.2d 535 (1st Cir. 1976) 11, 27
Securities Industries Ass'n v. *Board of Governors of the Federal Reserve System*, 468 U.S. 137 (1984) 8, 15, 17
Tcherepnin v. *Knight*, 389 U.S. 332 (1967) 26
The Fund of Funds, Ltd. v. *Vesco*, [1976-1977] Fed. Sec. L. Rep. (CCH) ¶ 95,644 (S.D.N.Y. July 21, 1976) 25
Union Nat'l Bank v. *Farmers Bank*, 786 F.2d 881 (8th Cir. 1986) 28
Union Planters Nat'l Bank v. *Commercial Credit Business Loans*, 651 F.2d 1174 (6th Cir.), cert. denied, 454 U.S. 1124 (1981) 29
United Housing Found., Inc. v. *Forman*, 421 U.S. 837 (1975) 6, 28
United States v. *Farris*, 614 F.2d 634 (9th Cir. 1979), cert. denied, 447 U.S. 926 (1980) 10-11, 27
Zabriskie v. *Lewis*, 507 F.2d 546 (10th Cir. 1974) 13
Zeller v. *Bogue Electric Mfg. Corp.*, 476 F.2d 795 (2d Cir.), cert. denied, 414 U.S. 908 (1973) 9, 15, 23, 25

Statutes, regulation and rule:

Bankruptcy Code, 11 U.S.C. 1101 *et seq.* (Ch. 11) 3
English Bills of Exchange Act of 1882, 45 & 46, Vict. ch. 61 19
Federal Reserve Act, ch. 252, § 402, 42 Stat. 1478 20
Investment Company Act of 1940, § 2(a)(32), 15 U.S.C. 80a-2(a)(32) 26
Securities Act of 1933, 15 U.S.C. 77a *et seq.*:
§ 2(1), 15 U.S.C. 77b(1) 7
§ 3(a)(3), 15 U.S.C. 77c(a)(3) 7, 8, 11, 14
§ 17(c), 15 U.S.C. 77q(c) 11
Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*:
§ 3, 15 U.S.C. 78c 11

Statutes, regulation and rule – Continued: Page

§ 3(a)(10), 15 U.S.C. 78c(a)(10) 6, 7, 8, 11, 14, 21

§ 10(b), 15 U.S.C. 78j(b) 3

Arkansas Securities Act, Ark. Stat. Ann. § 67-1256 (1980) 3

Uniform Negotiable Instruments Act, 1897 N.Y. Laws, ch. 612 18

U.C.C. § 3-104 (1977) 19

17 C.F.R. 240.10b-5 ..... 3, 25

Sup. Ct. R. 21.1(a) 16

Miscellaneous:

Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. Chi. L. Rev. 362 (1972) 11, 20, 21

Federal Securities Act: Hearing On H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 1st Sess. (1933) 19-20, 21

Guttman, *Article 3 Commercial Paper: An Updating of Well-Tried Concepts*, 11 How. L.J. 49 (1965) 19

H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933) 18, 21

H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934) 18

Hicks, *Commercial Paper: An Exempted Security Under Section 3(a)(3) of the Securities Act*, 24 UCLA L. Rev. 227 (1976) 19, 20

Jacobs, *The Meaning of "Security" Under Rule 10b-5*, 29 N.Y.L. Sch. L. Rev. 211 (1984) 13, 16, 22

Letter from Chester Morrill, Secretary of the Federal Reserve Board, to Rep. Sam Rayburn, Chairman, House Committee on Interstate and Foreign Commerce (Apr. 3, 1933) 19

Letter from Lane, Roloson & Co. to Sen. Duncan Fletcher (Apr. 1, 1933) 20

Letter from McCluney & Co. to Sen. Duncan Fletcher (Apr. 1, 1933) 20

J. Long, *Blue Sky Law* (rev. ed. 1988) 18

Miscellaneous – Continued: Page

2 L. Loss & J. Seligman, *Securities Regulation* (3d ed. 1989) 12, 22

Note, *The Economic Realities of Defining Notes as Securities under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 34 U. Fla. L. Rev. 400 (1982) 22

Pollock, *Notes Issued in Syndicated Loans – A New Test to Define Securities*, 32 Bus. Law. 537 (1977) 22

Securities Act Release No. 4412 (Sept. 20, 1961), 1 Fed. Sec. L. Rep. ¶ 2045 (Apr. 24, 1987) 15

Securities Act: Hearings on S. 875 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. (1933) 20, 21

Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 Bus. Law. 1567 (1980) 22

In the Supreme Court of the United States

OCTOBER TERM, 1989

No. 88-1480

BOB REVES, ET AL., PETITIONERS

v.

ARTHUR YOUNG & CO.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE SUPPORTING PETITIONERS

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

This case presents the question whether interest-bearing promissory notes, payable on demand, that are widely sold to the public as investments, are securities under the federal securities laws. The court of appeals held that such notes are not securities. The Securities and Exchange Commission, the agency principally responsible for the administration and enforcement of the federal securities laws, disagrees with both the analysis and the result reached by the court below. Since numerous situations arise in which notes similar to those involved here – some with a demand feature – are sold to the public as investments, the court of appeals' decision withdraws the protections of the federal securities laws from the investing public. That decision threatens to undermine the Commission's law

enforcement efforts over such investment instruments,[1] and to preclude private investors from seeking relief under the anti-fraud and registration provisions of the federal securities laws. The Court previously invited the Solicitor General to file a brief in this case at the certiorari stage expressing the views of the United States.

STATEMENT

1. The Farmers Co-Op of Arkansas and Oklahoma, Inc. (Co-Op) was an agricultural cooperative that provided a market and supply source for its 23,000 members located throughout northwest Arkansas and northeast Oklahoma. The Co-Op charged only a nominal membership fee. In addition to borrowing money from banks and other financial institutions, the Co-Op obtained funds for its day-to-day operations and business ventures from the sale of interest-bearing promissory notes, payable on demand, to its members and others with whom it conducted business, as part of a self-styled "investment program" (J.A. 5). Pet. App. A13-A14, A72, A76; J.A. 5; Pet. C.A. App. 1905-1908; see J.A. 4.

Notes sold through the Co-Op's investment program were available in the minimum denomination of $100, and carried fluctuating interest rates generally higher than those available from local financial institutions. The Co-Op determined the rate of interest each month based on current market rates; the notes were not collateralized. Pet. App. A14, A70, A72; Pet. C.A. App. 1773-1782, 1905-1920. In its widely circulated monthly newsletters, the Co-Op advertised that it had substantial assets backing the participants' "investments" in the program. Those advertisements acknowledged that the investments were not "Federal [*sic*] Insured," but stated that each investment was

[1] As a result of the sale of the notes at issue in this case, the Commission initiated an enforcement action for violations of the registration and antifraud provisions of the federal securities laws. The parties resolved that enforcement action by agreeing to the entry of consent injunctions. See *SEC* v. *White*, No. CA 86-2015 (W.D. Ark. May 1, 1986); Lit. Release No. 11,011 (Feb. 11, 1986), 35 S.E.C. Docket 84 (Feb. 25, 1986); Lit. Release No. 11,066 (Apr. 17, 1986), 35 S.E.C. Docket 874 (Apr. 29, 1986); Lit. Release No. 11,087 (May 1, 1986), 35 S.E.C. Docket 1076 (May 13, 1986).

"safe . . . secure . . . and available when you need it" (*e.g.*, J.A. 5; Pet. App. 70). The Co-Op disclosed no financial information to investors at the time of sale other than a statement of the Co-Op's total assets. It did, however, distribute condensed versions of audited financial statements to those persons who attended the Co-Op's annual meetings. Pet. App. A14-A15.

In the early 1980s, the Co-Op hired respondent, the accounting firm of Arthur Young & Company, to audit and report on its 1981 and 1982 financial statements. Respondent's representatives gave brief presentations at the Co-Op's 1982 and 1983 annual meetings explaining the Co-Op's general financial condition; some 350 of the Co-Op's members attended those meetings. Respondent's representatives also told the members that complete audited financial statements, together with respondent's report on them, were available at the Co-Op's headquarters. Pet. App. A15.

2. Early in 1984, the Co-Op filed for reorganization under Chapter 11 of the Bankruptcy Code, 11 U.S.C. 1101 *et seq.* At that time, some 1600 individual investors held Co-Op notes having a total face value of $10,000,000. Pet. App. A45, A73. After the Co-Op's financial collapse, petitioners, representing a class of purchasers of the Co-Op's notes, together with the Co-Op's trustee in bankruptcy, filed actions in the United States District Court for the Western District of Arkansas against the Co-Op, its principal officers and directors, respondent, and others.[2] Petitioners alleged, among other claims, that respondent and the other defendants had committed fraud in connection with the sale of securities—the Co-Op's notes—in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), Rule 10b-5, 17 C.F.R. 240.10b-5, and Section 67-1256 of the Arkansas Securities Act, Ark. Stat. Ann. (1980). Pet. App. A11-A12.[3]

[2] The district court later consolidated the complaints of the trustee and petitioners. In September 1985, the district court certified petitioners' class action. See *Robertson* v. *White*, 633 F. Supp. 954, 960 (W.D. Ark. 1986).

[3] With respect to respondent, petitioners essentially claimed that the accounting firm had fraudulently induced them to purchase the Co-Op's notes. Petitioners contended, among other things, that respondent deliberately failed

During extensive pretrial litigation, certain defendants, joined by respondent,[4] argued that the Co-Op's notes were not securities under either federal or state law, and thus sought dismissal of petitioners' securities law claims. After examining state law and precedent, together with analogous federal case law, the district court held that the Co-Op's notes were securities under the Arkansas Securities Act. Pet. App. A32-A81. The court found that "salient features of the notes offered by the [Co-Op] direct a conclusion that a broad scale [*sic*] offering of unsecured debt instruments to a passive public constitutes an investment transaction, rather than a commercial loan" (*id.* at A39-A40).[5] In a separate ruling several months later denying defendants' motion for summary judgment, the district court,

to follow generally accepted accounting principles in conducting its audits and thus overvalued one of the Co-Op's major assets. Petitioners also asserted that, had respondent used proper accounting techniques, "the Co-op's insolvency would have been readily apparent," and that respondent "avoided the correct accounting treatment and lied about its reasons for so doing, in order to inflate the assets and net worth of the Co-op" (Pet. App. A16).

[4] See Resp. Amicus Mem. With Respect To Whether The Co-Op Demand Notes Are Securities, *Robertson* v. *White*, No. 85-2044 (W.D. Ark.).

[5] The court rejected respondent's argument, based on *Great Western Bank & Trust* v. *Kotz*, 532 F.2d 1252, 1257 (9th Cir. 1976) (per curiam), that the demand feature of the Co-Op's notes took the notes outside the purview of the securities laws. The court first observed that *Great Western* itself had suggested that demand notes could be considered securities if " 'payment is dependent on the success of a risky enterprise' " (Pet. App. A74 (quoting *Great Western*, 532 F.2d at 1257)). The court then criticized respondent's argument as elevating "form over substance" and permitting

> the issuer, in this case the Co-op, to choose a form—*i.e.*, demand notes—which evades regulation, while allowing it to substantially practice the very evil which blue sky laws were designed to deter: the broadscale, public solicitation of large amounts of unsecured capital for deployment in a speculative venture.

Pet. App. A74-A75. The court observed that the Co-Op's notes "contain no restriction as to the use to which the funds may be put" and that this fact "further puts the 'investor' at risk" (*id.* at A75). Given these circumstances, the court concluded that the Co-Op's notes were securities, "notwithstanding the contention that under other circumstances such an instrument might not be considered an investment" (*id.* at A76).

apparently based on its earlier review of federal law, held that the Co-Op's notes were also securities under the federal securities laws. Pet. App. A30; see also *Robertson* v. *White*, 633 F. Supp. 954, 976 (W.D. Ark. 1986).

Petitioners' federal and state securities claims against respondent were tried to a jury. After a five-week trial, the jury found respondent liable for violating both federal and state securities laws and awarded petitioners over $6.1 million. Given petitioners' substantial settlements with the other defendants, the district court ordered that the jury's award be subject to a $5.7 million credit, conditioned on approval of those settlements. J.A. 29-30; Pet. App. A11, A17; Resp. C.A. App. 3.[6] Thereafter, the district court denied respondent's motion for judgment notwithstanding the verdict and its alternative motion for rehearing with respect to the damages issue. Resp. C.A. App. 11-12, 16-82.

Respondent appealed from the district court's denial of its post-trial motions. Respondent raised a number of claims, including renewing its contention that the Co-Op's demand notes were not securities under either federal or state securities laws. See Resp. C.A. Br. 33-37.[7]

3. The court of appeals reversed, holding that the Co-Op's "demand notes * * * are not 'securities' for purposes of either [the] federal or Arkansas securities acts" (Pet. App. A13).[8]

[6] Before trial, petitioners had reached settlements with most of the other defendants, who agreed to pay the class members a total of $5,734,780. See Resp. C.A. App. 3.

The bankruptcy trustee's separate common law claims against respondent were also tried to the jury. The jury returned verdicts in respondent's favor on those claims. Pet. App. A17.

[7] Respondent also contended that the district court erred in submitting petitioners' federal securities claim to the jury, arguing that respondent had no duty to make any disclosures to the class members, that the record contained no evidence that respondent caused any class member to purchase the Co-Op's notes, and that petitioners had presented no evidence showing that any class member relied on respondent's auditing statments or reports. Resp. C.A. Br. 9-19. Respondent also challenged the evidentiary support for and measure of the damages award (*id.* at 29-33), and claimed that the district court erred in certifying the class (*id.* at 37-39).

[8] In light of this disposition, the court of appeals did not reach the additional issues raised by respondent. See note 7, *supra*. Should the Court agree

The court of appeals observed that the Securities Exchange Act's definition of a security as including "any note" (15 U.S.C. 78c(a)(10)) does not resolve the issue because " 'Congress intended the application of [the federal securities acts] to turn on the economic realities underlying a transaction and not on the name appended thereto.' " Pet. App. A17-A18 (quoting *United Housing Found., Inc.* v. *Forman*, 421 U.S. 837, 849 (1975) (brackets in original)). The court further stated that the Co-Op's notes could not be securities unless they met the test set forth in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946), for identifying "investment contracts," another term included in the statutory definition. Pet. App. A19-A20.[9]

Before applying the *Howey* test, however, the court of appeals, in light of this Court's decision in *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681 (1985), considered whether the Co-Op's demand notes bear both a name included within the statutory definition of a security and "the usual characteristics of a security" (Pet. App. A20). Although the notes obviously bear the name of a security, the court concluded that "[t]he demand nature of the notes is very uncharacteristic of a security" (*id.* at A20, A21 (citing *Great Western Bank & Trust* v. *Kotz*, 532 F.2d 1252, 1257-1258 (9th Cir. 1976) (per curiam)). Accordingly, the court held that petitioners could not establish that they had purchased a security on the basis of the term "note" in the statutory definition.

The court of appeals therefore proceeded to apply the *Howey* test, and concluded that the notes failed to satisfy two elements of that test. First, after observing that the Co-Op's members " 'deposited' their money with the Co-Op in order to earn a higher return than could be obtained from a bank," the court found that "this transaction was much more akin to a commercial lending arrangement than an investment transaction" (Pet. App. A22). Second, the court concluded that the noteholders' expected return, an interest rate fixed by an established market rate, did not qualify as the requisite "reasonable expectation of profit" under *Howey*. *Id.* at A22-A23.

Having determined that the Co-Op's demand notes "were uncharacteristic of securities, and also failed the *Howey* test," the court of appeals held that those notes are not securities under the federal securities laws and therefore reversed the district court's denial of respondent's post-trial motions (Pet. App. A23).[10]

4. The court of appeals, with four judges dissenting, thereafter denied a petition for rehearing and suggestion for rehearing en banc.

with our analysis and hold that the Co-Op's notes are securities under the federal securities laws, the court of appeals would be in a position on remand to address the other challenges respondent raised below.

[9] Under the *Howey* test, the instrument must represent "an investment in a common enterprise with profits to come solely from the efforts of others." *Howey*, 327 U.S. at 301; *see* Pet. App. A21.

SUMMARY OF ARGUMENT

I. A. The term "security" is defined in both the Securities Act of 1933 and the Securities Exchange Act of 1934 to include "any note," subject to two qualifications. First, Section 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10), provides that the definition of a security "shall not include * * * any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months," and Section 3(a)(3) of the Securities Act, 15 U.S.C. 77c(a)(3), has a similar exemption from registration. Second, both Acts provide that the statutory definitions of a security are to apply "unless the context otherwise requires." 15 U.S.C. 77b(1); 15 U.S.C. 78c(a)(10).

In construing this language, the courts of appeals have resorted to three different tests to determine whether an instrument is a "note" within the meaning of the federal securities laws: (1) the "commercial-investment" test; (2) the "risk capital" test; and (3) the "family resemblance" test. The commercial-investment and risk capital approaches use multi-factor analyses to decide whether a transaction involves an investment covered by the securities laws. In contrast, the Second Circuit's family resemblance test is firmly premised on the statutory definitions

[10] The court of appeals also determined that the definitions of a security under the federal securities laws and the Arkansas Securities Act "are essentially the same" (Pet. App. A25 n.3). Accordingly, it concluded that the Co-Op's notes are not securities under state law. *Id.* at A23-A25.

and the prefatory "context" clause; as the statutes themselves suggest, the test begins with a presumption that the securities laws encompass any note unless "the context otherwise requires."

Although applying different tests for determining the coverage of the term "any note," both this Court and the lower courts have uniformly agreed that the exceptions for notes and certain other debt instruments having a maturity of less than nine months (15 U.S.C. 77c(a)(3); 15 U.S.C. 78c(a)(10)) should be narrowly construed to apply only to instruments that fit the general description of short-term commercial paper. See *Securities Industries Ass'n* v. *Board of Governors of the Federal Reserve System*, 468 U.S. 137, 150-152 (1984). This limiting construction, which follows the longstanding interpretation by the SEC, is necessary to avoid creating "a new and possibly replicable loophole in protecting investors through the Securities Acts." *Baurer* v. *Planning Group, Inc.*, 669 F.2d 770, 779 (D.C. Cir. 1981).

B. Of the three approaches followed by the lower federal courts, the Second Circuit's family resemblance test provides the best way to give content to the definitional provisions. Although *Landreth Timber Co.* v. *Landreth, supra,* did not fashion the test for determining when a note is a security, that decision indicated that the analysis must focus on the relevant statutory language, bearing in mind the overriding, broad purpose of the securities laws—to protect those who purchase financial instruments offered to the public as investments. The family resemblance test for defining a "note" is, we believe, more faithful to the statutory language than is either of the competing tests. That test first looks to and gives force to the statutory language, including the prefatory "context" clause, and presumes than an instrument labelled a "note" is covered by the securities laws unless it resembles certain categories of instruments clearly not used for investment purposes or falls within the statutory exclusion for short-term commercial notes. Purchasers of these instruments do not need the protection provided by the federal securities laws.

The family resemblance test also finds support in the general purpose of the federal securities laws to protect those who purchase financial instruments offered to the public as investments,

as well as in the relevant legislative history. Congress broadly defined "security" to encompass many financial instruments, including "notes." "Note" was understood during the 1920s and early 1930s, as it is today, to refer to a promise to pay, either on demand or at a fixed or determinable time in the future, a sum certain to order or to bearer. The legislative history of the exemption for commercial debt instruments of less than nine months duration confirms Congress's intention to extend coverage to other types of notes offered and sold to the public as investments.

Finally, the family resemblance test has other virtues. Unlike the two alternative approaches, which rely on open-ended, multi-factor analyses, the family resemblance test provides useful guidance and a greater degree of certainty regarding the status of particular types of notes under the securities laws.

II. A. The Co-Op's interest-bearing demand notes are within the statutory definition of a security. The notes do not meet either condition under the family resemblance test that would take them outside the statutory definition. The Co-Op, as part of a broad offering, sold the notes to the public in small denominations as an investment. Accordingly, these notes scarcely resemble the types of notes used in commercial transactions clearly outside the scope of the securities laws. Similarly, notes such as the Co-Op's demand notes, which are sold primarily to unsophisticated individual investors, do not fall within the statutory exclusion for short-term notes, since they do not fit the "general notion" of short-term commercial paper not generally available for purchase by ordinary investors.

B. Nor does the demand feature of the Co-Op's notes disqualify them from the definitional term "note" under the federal securities laws. A demand feature is not uncharacteristic of a note covered by these laws. See, *e.g.*, *Zeller* v. *Bogue Electric Mfg. Corp.*, 476 F.2d 795, 800-801 (2d Cir.), cert. denied, 414 U.S. 908 (1973). In other words, "[i]t is the character of the note, not its maturity date, which determines coverage" under the securities laws *SEC* v. *Continental Commodities Corp.*, 497 F.2d 516, 525 (5th Cir. 1974). The key factors are that the Co-Op, as part of a broad offering, sold the notes to the public in small denominations as an investment. In focusing exclusively

on the demand feature of the notes, the court of appeals mistakenly disregarded those essential features of the transactions at issue. And as other courts have uniformly recognized, where, as here, a debt instrument is offered to the general public in small denominations as an investment, the instrument is a security, regardless of the length of the instrument's term.[11]

III. A. Because the Co-Op's notes fall within the term "note" in the statutory definition of a security, those instruments need not also satisfy the "investment contract" test of *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946). In *Landreth Timber Co.* v. *Landreth, supra,* this Court made clear that "applying the *Howey* test to traditional stock and all other types of instruments listed in the statutory definition would make the Acts' enumeration of many types of instruments superfluous" (471 U.S. at 692). Since the Co-Op's notes that were sold to the general public in small denominations as investments are "notes" within the statutory definition, they need not also satisfy *Howey's* residual test.

B. Even if the *Howey* test governed here, the court of appeals misapplied that test. First, the record shows that the Co-Op's notes were issued to and purchased by an unsophisticated public as investments. The notes thus satisfy the "investment" element of the investment contract test. Second, the noteholders' expected return—a fixed rate of interest—satisfies the "profit" element of the *Howey* test.

ARGUMENT

INTEREST-BEARING PROMISSORY NOTES, PAYABLE ON DEMAND, THAT ARE WIDELY OFFERED AND SOLD TO THE PUBLIC AS INVESTMENTS, ARE SECURITIES UNDER THE FEDERAL SECURITIES LAWS.

I. A Note Is A Security Within The Statutory Definition, Unless It Resembles Certain Types Of Notes Not Used For Investment Purposes That Are Clearly Outside The Scope Of The Federal Securities Laws

A. The definition of "security" is fundamental to the federal securities laws, since that term "controls the scope of th[e]

[11] See, *e.g.*, *SEC* v. *American Bd. of Trade*, 751 F.2d 529, 538-540 (2d Cir. 1984); *Hunssinger* v. *Rockford Business Credits, Inc.*, 745 F.2d 484, 492 (7th Cir. 1984); *United States* v. *Farris*, 614 F.2d 634, 641 (9th Cir. 1979), cert. denied, 447 U.S. 926 (1980); *Lawler* v. *Gilliam*, 569 F.2d 1283, 1286-1287 (4th Cir. 1978); *SEC* v. *World Radio Mission*, 544 F.2d 535, 537-540 (1st Cir. 1976); *McClure* v. *First Nat'l Bank*, 497 F.2d 490, 493-494 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975).

Act[s]." *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 350 (1943). The term "security" is defined in both the Securities Act and the Exchange Act broadly to include "any note." That sweeping inclusion is, however, subject to two qualifications. First, the definition of a "security" in the Exchange Act excludes "any note, draft, bill of exchange, or banker's acceptance" which has a "maturity at the time of issuance of not exceeding nine months," and the Securities Act has a similar exemption from registration. These are often referred to as the "commercial paper" exceptions.[12] Second, both the reference to "any note," and the exclusion for certain types of instruments with maturities less than nine months, are qualified (as are all other statutory definitions in both Acts) by the phrase, "unless the context otherwise requires."[13]

[12] Section 3(a)(3) of the Securities Act, 15 U.S.C. 77c(a)(3), exempts from the Act's registration requirements (although not from the antifraud provisions, see Section 17(c) of the Securities Act, 15 U.S.C. 77q(c)) "[a]ny note, draft, bill of exchange, or banker's acceptance * * * which has a maturity at the time of issuance of not exceeding nine months * * *." Similarly, the proviso in Section 3(a)(10) of the Exchange Act, 15 U.S.C. 78c(a)(10), excludes from the definition of security "any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months * * *." Section 3(a)(3) of the Securities Act, 15 U.S.C. 77c(a)(3), also requires that such exempted notes be used for "current transaction[s]," a requirement not found in Section 3(a)(10) of the Exchange Act. There are no reported legislative comments regarding this difference between the commercial paper exceptions in the Securities Act and the Exchange Act. See Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. Chi. L. Rev. 362, 398 (1972). The Court has "repeatedly ruled that the definitions of 'security' in § 3(a)(10) of the 1934 Act and § 2(1) of the 1933 Act are virtually identical," and has instructed that those terms be so treated. *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 686 n.1 (1985). In light of this longstanding interpretive rule, the apparent distinction has not been considered material.

[13] The full text of the definition of "security" as it appears in the Exchange Act, 15 U.S.C. 78c, provides in pertinent part:

> (a) Definitions.
>
> When used in this chapter, unless the context otherwise requires—
>
> * * * * * *
>
> (10) The term "security" means any note, stock, treasury stock,

Although this Court has not previously resolved the proper definition of a "note" for purposes of the federal securities laws, it has observed that the word "note" is "a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context." *Landreth Timber Co.* v. *Landreth*, 471 U.S. at 694. For that reason, the Court in *Landreth* said it would "expressly leave until another day" (*ibid.*) the question whether an instrument might be shown to be a "note" for purposes of the statutory definition of a security " 'by proving [only] the document itself' " (*ibid.*, quoting *Joiner Leasing Corp.*, 320 U.S. at 355).

The lower courts have also recognized the wide diversity in the types of instruments that are demoninated "notes," and have, accordingly, uniformly rejected a literal reading of the statutory definition. Instead, they have resorted to three different tests to determine when an instrument described as a "note" is to be regarded as a "security" for purposes of the securities laws: (1) the "commercial-investment" test; (2) the "risk capital" test; and (3) the "family resemblance" test. See generally 2 L. Loss & J. Seligman, *Securities Regulation* 880 (3d ed. 1989).[14]

---

bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof of the maturity of which is likewise limited.

[14] Most courts of appeals use the "commercial-investment" test. See, *e.g.*, *Futura Development Corp.* v. *Centex Corp.*, 761 F.2d 33, 40-41 (1st Cir.), cert. denied, 474 U.S. 850 (1985); *C.N.S. Enterprises, Inc.* v. *G & G Enterprises, Inc.*, 508 F.2d 1354, 1357-1362 (7th Cir.), cert. denied, 423 U.S. 825 (1975); *Zabriskie* v. *Lewis*, 507 F.2d 546, 550-552 (10th Cir. 1974); *Bellah* v. *First Nat'l Bank*, 495 F.2d 1109, 1111-1114 (5th Cir. 1974); *Lino* v. *City Investing Co.*, 487 F.2d 689, 693-696 (3d Cir. 1973).

The Ninth Circuit, sometimes joined by the Sixth Circuit, uses the "risk capital" test. See, *e.g.*, *Great Western Bank & Trust* v. *Kotz*, 532 F.2d 1252, 1256-1260 (9th Cir. 1976) (per curiam); see *American Bank & Trust* v. *Wallace*, 702 F.2d 93, 96 (6th Cir. 1983).

As we stated previously, the Second Circuit uses the "family resemblance" test. See, *e.g.*, *Exchange Nat'l Bank* v. *Touche Ross & Co.*, 544 F.2d 1126, 1137-1139 (2d Cir. 1976).

The commercial-investment approach analyzes a number of factors to decide the ultimate issue "whether the plaintiffs are simply borrowers [or lenders] in a commercial transaction who are not protected by the [securities laws] or investors in a securities transaction who are protected." *C.N.S. Enterprises, Inc.* v. *G & G Enterprises, Inc.*, 508 F.2d 1354, 1359 (7th Cir.), cert. denied, 423 U.S. 825 (1975). These factors include (1) whether the obligations are sold or issued to a single party or to a large class of investors; (2) the characterization of the instruments in relevant financial statements or by the parties themselves; (3) whether the proceeds are to be used to purchase specific assets or services (commercial) or for general financing purposes (investment); (4) the extent of reliance on the efforts of others; (5) whether the noteholders are protected by collateral; (6) the number of notes issued, the number of payees, and the dollar amount of the transaction; and (7) the length of the note's term. *C.N.S. Enterprises, Inc.*, 508 F.2d at 1359, 1361. See also Jacobs, *The Meaning of "Security" Under Rule 10b-5*, 29 N.Y.L. Sch. L. Rev. 211, 372-375 (1984) (citing other factors used by various courts).

The risk capital test, which begins with the commercial-investment test, proceeds to determine "whether the funding party invested 'risk capital.' " *Great Western Bank & Trust* v. *Kotz*, 532 F.2d 1252, 1257 (9th Cir. 1976) (per curiam). Like the commercial-investment approach, the risk capital test involves a multi-factor analysis. The factors include (1) the duration of the instrument; (2) whether it is collateralized; (3) the form of

the obligation; (4) the circumstances of the issuance; (5) the relationship between the amount borrowed and the size of the borrower's business; and (6) the contemplated use of the funds. *Id.* at 1257-1258.

On the other hand, the Second Circuit's "family resemblance" test, developed in a series of opinions authored by Judge Henry Friendly, is premised on the language of the statutory definition and the prefatory "context" clause. This approach begins with the plain language of the statute. It presumes that the securities laws encompass any note unless "the context otherwise *requires*." *Exchange Nat'l Bank* v. *Touche Ross & Co.*, 544 F.2d 1126, 1138 (2d Cir. 1976) (emphasis in original). A note is, accordingly, regarded as a security unless it bears "a strong family resemblance" to certain categories of notes that are clearly outside the scope of the securities laws. In *Exchange Nat'l Bank*, 544 F.2d at 1138, the Second Circuit listed the following categories of notes that fall outside the scope of the securities laws (*ibid.*):

> the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).

In *Chemical Bank* v. *Arthur Andersen & Co.*, 726 F.2d 930, 939 (2d Cir.), cert. denied, 469 U.S. 884 (1984), the court added to that list "notes evidencing loans by commercial banks for current operations."

Although the lower courts have disagreed over the proper test for determining what is a "note," both this Court and the lower courts have uniformly construed the exemption for "any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months" (15 U.S.C. 77c(a)(3); 15 U.S.C. 78c(a)(10)) to refer only to notes that fit "the general notion of 'commercial paper.'"

Zeller, 476 F.2d at 800. See *Securities Industries Ass'n* v. *Board of Governors of the Federal Reserve System*, 468 U.S. 137, 150-152 (1984); *Holloway* v. *Peat, Marwick, Mitchell & Co.*, No. 87-1486 (10th Cir. July 11, 1989), slip op. 11-12; *SEC* v. *American Bd. of Trade*, 751 F.2d 529, 538-540 (2d Cir. 1984); *Baurer* v. *Planning Group, Inc.*, 669 F.2d 770, 775-777 (D.C. Cir. 1981); *Sanders* v. *John Nuveen & Co.*, 463 F.2d 1075, 1078-1080 (7th Cir.), cert. denied, 409 U.S. 1009 (1972). In so ruling, they have relied on the legislative history of the exemption (discussed at pp. 19-22, *infra*) and on the SEC's consistent and longstanding interpretation of this provision. See Securities Act Release No. 4412 (Sept. 20, 1961), 1 Fed. Sec. L. Rep. (CCH) ¶ 2045 (Apr. 24, 1987).

More fundamentally, these courts have noted that "[t]o exclude short-term notes that represent genuine investments from the coverage of the 1934 Act would serve no discernible statutory purpose" and "would create a new and possibly replicable loophole in protecting investors through the Securities Acts." *Baurer*, 669 F.2d at 776, 779. As Judge Friendly has observed:

> It is inconceivable that Congress intended § 3(a)(3) to exempt from registration a periodic public offering of the issuer's own notes to small investors simply because their maturity was less than nine months. It is almost equally unlikely that Congress meant that an issuer soliciting broad public investment in notes issued for general corporate purposes should be able to avoid the anti-fraud provisions of the 1934 Act simply by arranging that they should have "a maturity at the time of issuance of not exceeding nine months."

American Bd. of Trade, 751 F.2d at 539-540.

B. The different approaches developed by the courts of appeals for determining whether an instrument is a "note" obviously overlap to a significant degree. We do not doubt that those approaches would produce similar results in many cases. As one commentator has correctly observed, "[d]espite the diversity of [the three] approaches, they do contain a common core; that is, an issue of notes of whatever maturity sold to more

than a few purchasers who are not in the business of loaning money will be deemed securities." Jacobs, *supra*, 29 N.Y.L. Sch. L. Rev. at 381-382. Yet even though the approaches reflect a "common core," we believe that the Second Circuit's family resemblance approach is, for several reasons, superior to either the commercial-investment test or the risk capital tests. We consequently urge the Court to adopt the Second Circuit's method for implementing the statutory definition.[13]

1. An important virtue of the family resemblance test is that it conforms most closely to the statutory language. As this Court indicated in *Landreth Timber Co.* v. *Landreth*, 471 U.S. at 685, in determining the meaning of "security," as in other matters, it is fundamental to begin with the language of the statute itself. It is, after all, the statute that is law. To be sure, the Court also indicated that the fact that an instrument bears one of the labels mentioned in the statutory definition "is not of itself sufficient to invoke the coverage of the Acts." *Id.* at 686. Even with respect to traditional stock—"the paradigm of a security" (*id.* at 693, quoting *Daily* v. *Morgan*, 701 F.2d 496, 503 (5th Cir. 1983))—the Court stated that it was necessary to ask whether the stock in question possesses the characteristics "traditionally associated with common stock" (471 U.S. at 687), and whether reading the securities laws to apply to the sale of stock in question would comport "with Congress' remedial purpose in enacting the legislation to protect investors" (*ibid.*).

[13] No party below, including the SEC as amicus curiae on the petition for rehearing, requested the court of appeals to follow the Second Circuit's approach. Nevertheless, as we previously pointed out in our brief filed in response to the Court's invitation in this case (Br. 17 n.32), it is not inappropriate for this Court to consider that argument in the first instance. The question presented by petitioners—whether the Co-Op's notes are securities under the federal securities laws (Pet. i)—includes the subsidiary (and substantial) issue of the proper test for determining coverage under those laws. See Sup. Ct. R. 21.1(a). Furthermore, the prudential considerations that ordinarily weigh against the Court's addressing an argument not squarely presented below do not obtain here. Federal courts have grappled for years over the proper test for determining whether an instrument is a "note." Thus, there is no doubt that the issue has been adequately addressed by the lower courts. Cf. *Carlson* v. *Green*, 446 U.S. 14, 17 n.2 (1980); *Blonder-Tongue Laboratories, Inc.* v. *University of Illinois Found.*, 402 U.S. 313, 320 n.6 (1971).

Nevertheless, the Court clearly rejected the contention that the inquiry into whether an instrument is a security should be conducted exclusively in terms of the economic substance of the transaction, rather than by asking, at least as an initial matter, whether the instrument falls within the terms of one of the categories specifically enumerated in the statute.

The Second Circuit's approach to defining a "note," like *Landreth's* approach to the definition of "stock," begins with the words of the statute. The family resemblance test starts with the language broadly defining a security to include "any note," and the language excluding from that definition "any note • • • which has a maturity at the time of issuance of not exceeding nine months," and then construes these provisions in light of the prefatory clause "unless the context otherwise requires." See, *e.g.*, *American Bd. of Trade*, 751 F.2d at 538-540; *Chemical Bank*, 726 F.2d at 939; *Exchange Nat'l Bank*, 544 F.2d at 1138. Thus, a note of more than nine months maturity is initially presumed to be a security, whereas a note of less than nine months maturity is initially presumed not to fall within the statutory definition. At that point, "[a] party asserting that a note of more than nine months maturity is not within the 1934 Act (or that a note with a maturity of nine months or less is within it) • • • has the burden of showing that the context otherwise *requires*." *Exchange Nat'l Bank*, 544 F.2d at 1137-1138 (emphasis in original).

By using the "context" clause in this manner, the family resemblance approach is at once faithful to the plain meaning of the statute, and yet affords the flexibility that all courts and commentators have recognized is necessary in order to give effect to the overriding purposes of the securities laws. The commercial-investment and the risk capital approaches, in contrast, provide the necessary flexibility (indeed, as discussed below, they may provide too much flexibility), but they have no apparent nexus to the language of the statutory definition. See also *Securities Industries Ass'n*, 468 U.S. at 153-154 (rejecting the use of a "functional test" to define the word "note" under the Glass-Steagall Act).

2. The family resemblance test also finds support in the general purposes and history of the federal securities laws. The

overriding purpose of the securities laws is to ensure that persons who purchase financial instruments offered to the public as investments are fully and accurately informed about the investment's relevant features, including its risks. Congress enacted the Securities Act in response to President Roosevelt's call for federal regulation of "traffic in investment securities." H.R. Rep. No. 85, 73d Cong., 1st Sess. 1 (1933). Congress was well aware that "the public in the past ha[d] sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities" (*ibid.*). Accordingly, Congress insisted that sellers of securities must not conceal any important information from the "buying public" (*id.* at 2); see also H.R. Rep. No. 1383, 73d Cong., 2d Sess. 1-5 (1934).

The family resemblance test is consistent with this overriding purpose. By using the "context" clause to exclude from the definition of "note" certain instruments that are acquired in typical commercial loan transactions, the test excludes from the scope of the definition of "note" only those transactions where Congress's objectives clearly are not implicated. And by invoking the "context" clause to limit the scope of the exclusion for notes of less than nine months maturity to transactions in commercial paper (or its close equivalent), the Second Circuit's approach ensures that the exclusion is not used to frustrate or circumvent the purposes of the statute.

The family resemblance test is also consistent with the legislative history. Although little direct evidence exists as to why Congress included the term "any note" in the definition of a security, the historical context suggests that inclusion of this term reflected a congressional desire to define "security" broadly to encompass a wide variety of financial instruments.[16] "Note" was understood at that time, as it is today, to refer to a promise to pay, either on demand or at a fixed or determinable time in the future, a sum certain to order or to bearer. This was the definition used in the Uniform Negotiable Instruments Act (1897 N.Y. Laws ch. 612), which was first enacted in New York

[16] State securities statutes enacted before 1933 also defined "security" to include "notes." See J. Long, *Blue Sky Law* § 2.01 (rev. ed. 1988).

in 1897, and had been enacted in all States by 1924.[17]

That Congress intended to provide protection broadly to members of the public who buy notes as investments is particularly evident from the legislative history of the statutory exemption for notes and certain other debt instruments of less than nine months maturity. The list of excluded instruments, "note, draft, bill of exchange or banker's acceptance," had a well-understood meaning in ordinary business (as opposed to investment) transactions: it referred to what is generally called commercial paper.[18] Congress recognized that parties to such transactions in the commercial paper market, in which ordinary members of the investing public rarely participated, did not need the same protection as the public at large.

Originally, the draft of the bill that became the Securities Act contained no exemption for short-term commercial paper. However, testimony and comments of members of the Federal Reserve Board, the Investment Bankers Association of America, and various commercial paper dealers prompted congressional action. These statements indicated that a limited exemption from registration was warranted since these business financing instruments were not sold to the general public, but rather to a sophisticated class of professionals.[19] For example, as one representative of the investment banking industry explained:

> Now, commercial paper and promissory notes are not sold to the public. You and I are never going to lose any money

[17] See Guttman, *Article 3 Commercial Paper: An Updating of Well-Tried Concepts*, 11 How. L.J. 49, 51 n.23 (1965). The Uniform Negotiable Instruments Law (NIL) was based on the English Bills of Exchange Act of 1882, 45 & 46 Vict. ch. 61, which was in turn a codification of the prior law of negotiable instruments. See Guttman, *supra*, 11 How. L.J. at 51. The NIL has been superseded by the Uniform Commercial Code, which retains the same definition of note. See U.C.C. § 3-104 (1977).

[18] See Hicks, *Commercial Paper: An Exempted Security Under Section 3(a)(3) of the Securities Act*, 24 UCLA L. Rev. 227, 235 n.37 (1976).

[19] See Letter from Chester Morrill, Secretary of the Federal Reserve Board, to Rep. Sam Rayburn, Chairman, House Committee on Interstate and Foreign Commerce (Apr. 3, 1933), quoted in *Federal Securities Act: Hearing on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d

> nor is any of the public going to lose any money if that man should happen to default in those notes. Yet under this bill those notes would be characterized and classified as securities. They must be exempted unless you wish to stop the trade of the country in its ordinary rules.

Federal Securities Act: Hearing on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 179 (1933) (statement of William C. Breed, counsel for the Investment Bankers Association of New York, New Jersey, and Connecticut; also representing the Investment Bankers Association of America) [hereinafter *House Hearing*].[20]

The specialized uses of the exempted financial instruments show why ordinary public investors did not purchase them. This group of instruments—"note, draft, bill of exchange, or banker's acceptance"—appears to have been taken directly from Section 13 of the Federal Reserve Act, ch. 252, § 402, 42 Stat. 1478, and the Federal Reserve Board's Regulation A.[21] These

Cong., 1st Sess. 180 (1933) [hereinafter *House Hearing*]; *House Hearing* 180-181 (statement of William C. Breed, counsel for the Investment Bankers Association of New York, New Jersey, and Connecticut; also representing the Investment Bankers Association of America); Letter from Lane, Roloson & Co. to Sen. Duncan Fletcher (Apr. 1, 1933), quoted in *Securities Act: Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 94 (1933) [hereinafter *Senate Hearings*]; Letter from McCluney & Co. to Sen. Duncan Fletcher (Apr. 1, 1933), quoted in *Senate Hearings* 95.

The Federal Reserve Board included in its comment letter a draft of the proposed exemption in substantially the form in which it ultimately was adopted by Congress. See *House Hearing* 180; *Senate Hearings* 120.

[20] When questioned regarding possible general public interest in investing in these notes, Mr. Breed remarked: "I do not think that there would be much market among the public for commercial short-term paper. It is almost wholly a banking proposition." *House Hearing* 182. Breed also observed that "[i]t might be that a great big rich man would say, 'Well, I will take some of this short-term paper,' and he might buy it from his bank, but the ordinary public would have nothing whatever to do with it." *Id.* at 181. See also Comment, *supra*, 39 U. Chi. L. Rev. at 368-369 (in 1920s and early 1930s, banks purchased approximately 99% of commercial paper sold on the market).

[21] Section 13 of the Federal Reserve Act, which provides for discounting of commercial paper, used the terms "notes, drafts, and bills of exchange." 42 Stat. 1478. Regulation A contained definitions of these terms as well as one for "banker's acceptance." See Hicks, *supra*, 24 UCLA L. Rev. at 235 n.37.

commercial paper notes, generally of high quality, were primarily bought and sold within the business community to finance short-term and seasonal needs. See *House Hearing* 179.[22] Congress thus excepted from the securities laws only those notes used in this narrow commercial context, described in the legislative history as commercial paper having very short maturation periods (four to six months), sold in large denominations, discountable at the Federal Reserve Bank, and already generally exempt from registration under the securities laws of 32 States. See H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933); *House Hearing* 179-183.

In sum, the legislative history of Section 3(a)(3) of the Securities Act, which applies equally to the Exchange Act's exclusion in Section 3(a)(10),[23] shows that Congress intended to extend federal securities law protection to a wide variety of financial instruments denominated "note" that were offered and sold to the public as investments. At the same time, Congress specifically exempted from coverage only a narrow category of "notes" that generally were not part of ordinary investment transactions, *i.e.*, "short-term paper of the type available for discount at a Federal Reserve Bank and of a type which is rarely bought by private investors." H.R. Rep. No. 85, *supra*, at 15. Congress's specific and limited exemptions for short-term com-

[22] Congress heard testimony both underscoring the unique nature of these financial instruments and emphasizing that an exemption was essential to prevent "hardship" to the banking institutions which comprised the market for true commercial paper. See *Senate Hearings* 94-95. And the Federal Reserve Board itself supported this position, stressing that the provisions of the Securities Act should not apply "to short-time paper issued for the purpose of obtaining funds for current transactions in commerce, industry or agriculture and purchased by banks and corporations as a means of employing temporarily idle funds." *House Hearing* 180.

[23] There are no reported legislative comments regarding the Exchange Act's exclusion of short-term notes. See Comment, *supra*, 39 U. Chi. L. Rev. at 397. But in light of the virtually identical definitions of "security" in the Securities Act and the Exchange Act, courts have routinely used the legislative history surrounding the Securities Act's exemption for short-term commercial notes to interpret the Exchange Act's exclusion. See, *e.g.*, *American Bd. of Trade*, 751 F.2d at 538-540; *Bauer v. Planning Group, Inc.*, 669 F.2d 770, 775-777 (D.C. Cir. 1981); *McClure*, 497 F.2d at 493 n.1.

mercial notes reflected its conclusion that, in light of the sophisticated character of the participants in the specialized commercial paper market as it existed in the 1920s and early 1930s, these exemptions would not deny the needed protections of the federal securities laws to ordinary investors in other debt instruments.

3. Apart from being consistent with the statutory scheme of the federal securities laws, the family resemblance test has other virtues. First, that test avoids many of the analytical difficulties inherent in the other approaches. As Judge Friendly pointed out, the commercial-investment and risk capital approaches inject a variety of factors into the analysis "without any instructions as to relative weights." *Exchange Nat'l Bank*, 544 F.2d at 1137. The determination whether any particular note is a security thus becomes both highly subjective and unpredictable. See *ibid.*; see also Jacobs, *supra*, N.Y.L. Sch. L. Rev. 211, 371-372, 377 (1984).[24] Indeed, many commentators have pointed out the difficulties in applying these two approaches.[25]

The Second Circuit test, in contrast, is easier to apply. It specifies a list of categorical exclusions from the statutory defini-

---

[24] Professor Jacobs, for example, has observed that factors used in opinions applying the commercial-investment dichotomy

> are not necessarily the only appropriate ones. Prior opinions are of limited utility since every case is highly fact-oriented, each applicable factor need not receive the same weight, and courts have not uniformly applied the standards. An inability to accurately predict the outcome of a particular case is therefore an inherent drawback of the commercial-investment dichotomy approach.

Jacobs, *supra*, 29 N.Y.L. Sch. L. Rev. at 371-372 (footnotes omitted). Professor Jacobs also notes that the same drawback applies to the risk capital test's multi-factor analysis. *Id.* at 377.

[25] See, *e.g.*, 2 L. Loss & J. Seligman, *Securities Regulations* 881-882 (3d ed. 1989); Pollock, *Notes Issued in Syndicated Loans—A New Test to Define Securities*, 32 Bus. Law. 537, 541-543 (1977); Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 Bus. Law. 1567, 1603 (1980); Note, *The Economic Realities of Defining Notes as Securities under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 34 U. Fla. L. Rev. 400, 418 (1982).

tion for those notes used in obviously commercial, as opposed to investment, transactions (see p. 14, *supra*). The family resemblance test thus provides better guidance to parties to a transaction to determine if the instruments they plan to use will be protected under the securities laws. Cf. *Landreth*, 471 U.S. at 696-697 (parties to a transaction should be able to determine whether the securities laws apply before engaging in extended discovery and litigation over "elusive" concepts).

II. The Co-Op's Interest-Bearing, Demand Promissory Notes Are Securities Within The Statutory Definition, Since They Do Not Resemble Those Categories Of Notes Used For Commercial Purposes That Are Clearly Outside The Scope Of The Federal Securities Laws

A. The Co-Op's interest-bearing, demand promissory notes are "notes" within the statutory definition of a security. These notes are securities under the federal securities laws unless one of two conditions is satisfied: either (1) the notes bear "a strong family resemblance" to certain categories of notes that are clearly outside the scope of the securities laws, such as "notes evidencing loans by commercial banks for current operations," *Chemical Bank*, 726 F.2d at 939, "note[s] delivered in consumer financing, • • • [or] short-term note[s] secured by a lien on a small business or some of its assets," *Exchange Nat'l Bank*, 544 F.2d at 1138; or (2) the Co-Op's notes fall within the statutory exclusion for those instruments that fit the "general notion" of short-term commercial paper not generally available for purchase by ordinary investors and having a maturity not exceeding nine months. *Zeller*, 476 F.2d at 800.

The Co-Op's notes fail to meet either condition. The Co-Op, as part of a broad offering, sold the notes to the public in small denominations as an investment. Not only did the Co-Op style and advertise the public offering as an "investment program" (J.A. 5), the Co-Op underscored that point by having the notes carry fluctuating interest rates generally higher than those available from local financial institutions. Furthermore, the so-called "lenders" here were not commercial banks; to the con-

trary, they were farmers and other nonprofessional investors. The transactions, moreover, did not involve consumer financing, and the notes were neither insured nor collateralized. See, *e.g.*, Pet. App. A70-A72; Pet. C.A. App. 1773-1782, 1905-1920. Accordingly, these notes scarcely resemble the types of notes used in commercial transactions identified by the Second Circuit as clearly falling outside the scope of the securities laws. Compare *Chemical Bank*, 726 F.2d at 939; *Exchange Nat'l Bank*, 544 F.2d at 1138.

Similarly, notes such as the Co-Op's demand notes, which are sold primarily to unsophisticated individual investors, do not fall within the statutory exclusion for short-term notes. As an initial matter, we observe that there is some question whether a demand note should be regarded as a note "which has a maturity at the time of issuance of not exceeding nine months." A demand note has an indefinite term, and thus may not be regarded as having a fixed term of less than nine months for purposes of the federal securities laws. But even if demand notes sold in a commercial context might otherwise fall within the terms of the exclusion, the Co-Op notes still would not qualify, since they do not fit the "general notion" of short-term commercial paper not generally available for purchase by ordinary investors. Petitioners therefore have sustained their burden under the family resemblance test of showing that the Co-Op's notes remain within the statutory definition and are thus securities under the federal securities laws.[26]

B. The court of appeals nevertheless concluded (Pet. App. A20-A21) that the demand feature of the Co-Op's notes disqualified them from the definitional term "note" under the federal securities laws. However, a demand feature is not un-

[26] Should the Court be disinclined to adopt the Second Circuit's family resemblance test, the Court should nonetheless hold that the Co-Op's notes qualify as securities under either the commercial-investment approach or the risk capital test used by the other courts of appeals. The record in this case shows that the Co-Op widely offered its unsecured notes to the public and sold them to hundreds of farmers in small denominations as an investment opportunity. See, *e.g.*, Pet. App. A70-A72; Pet. C.A. App. 1773-1782, 1905-1920. In our view, the Co-Op's notes are securities under either of the other two approaches employed by the circuits.

characteristic of a note covered by the securities laws. Indeed, at the time Congress enacted the securities laws, "note" was understood, as it is today, to include "demand" instruments. The federal securities laws reflect this common understanding. See pp. 19-22, *supra*.

Consistent with this understanding, most lower courts that have addressed the issue have concluded that a demand feature does not preclude a note from being regarded as a security. In *Zeller* v. *Bogue Electric Mfg. Corp.*, *supra*, for example, the Second Circuit held that a demand interest-bearing promissory note, issued to a party "in the position of an investor," is a security in the form of a "note" whose sale could give rise to a claim under Rule 10b-5, when it does not "fit[] the general notion of 'commercial paper' " (476 F.2d at 800, 801).[27] In other words, "it is the character of the note, not its maturity date, which determines coverage" under the securities laws. *Continental Commodities Corp.*, 497 F.2d at 525; see *Holloway*, slip op. 21-22.[28]

Respondent contends (Br. in Opp. 8-9) that the notes' demand feature, by providing "instant liquidity," eliminates the element of risk essential to an investment transaction covered by the securities laws. But these notes obviously contained elements of risk—the notes were neither insured nor collaterized. Furthermore, the Co-Op marketed the notes' demand

[27] Accord *Briggs* v. *Sterner*, 529 F. Supp. 1155, 1168 (S.D. Iowa 1981) (demand note held to be a security); *The Fund of Funds, Ltd.* v. *Vesco*, [1976-1977] Fed. Sec. L. Rep. (CCH) ¶ 95,644 at 90,193-90,195 (S.D.N.Y. July 21, 1976) (same).

[28] The court of appeals mistakenly relied on the statement in *Great Western Bank & Trust* v. *Kotz*, *supra*, that a "demand or short-term note is almost *ipso facto* not a security * * *." First, although for the reasons discussed above (see pp. 19-22, *supra*) we disagree with the Ninth Circuit's statement, *Great Western* involved a loan transaction between a bank and an individual (on behalf of a corporation), which was secured in part by collateral in the form of a bank account with a $300,000 mandatory minimum balance. That commercial loan arrangement is quite different from the public offering of an investment opportunity at issue here. Second, although ultimately holding that the transaction did not involve a "note" within the meaning of the federal securities laws, the *Great Western* court made clear that, of the numerous factors it considered, no single factor compelled its conclusion. 532 F.2d at 1258.

feature not as an aspect of the investment's reduced risk, but as a feature for the purchasers' convenience. See, *e.g.*, J.A. 5 ("NOTES ARE PAYABLE ON DEMAND, so any time you need your money we will write you a check. There is no waiting period." (monthly newsletter)). Moreover, given that the Co-Op advertised the notes as "investments" and announced monthly the current rate of interest, it is apparent that the Co-Op anticipated that noteholders would leave their money with it for extended periods of time. The record confirms that many noteholders in fact did so. See, *e.g.*, Pet. C.A. App. 1491, 1514, 1517, 1526, 1542, 1548, 1558, 1600 (letters of noteholders at time of Co-Op's bankruptcy to trustee in bankruptcy).

That there should be no special exemption for demand notes is confirmed by the fact that a "demand" feature does not preclude other types of instruments from being considered securities. See, *e.g.*, *SEC* v. *United Benefit Life Ins. Co.*, 387 U.S. 202, 205 (1967) (variable annuities); see also Section 2(a)(32) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(a)(32) (mutual fund shares). Even if the Co-Op's demand notes are viewed as analogous to an interest-bearing savings account or an account with a savings and loan association, they would not be excluded from the definition of a security on that basis. In *Tcherepnin* v. *Knight*, 389 U.S. 332 (1967), this Court held that withdrawable capital shares in a state-chartered savings and loan association are securities.[29]

Contrary to respondent's contention (Br. in Opp. 7), the "critical feature" of the Co-Op's notes is not their demand feature. The key factors are that the Co-Op, as part of a broad offering, sold the notes to the public in small denominations as an investment. In focusing exclusively on the demand feature of the notes, the court of appeals mistakenly disregarded those essential features of the transactions at issue. As other courts

[29] Although the Court's reasoning in *Marine Bank* v. *Weaver*, 455 U.S. 551, 558 (1982), would exclude certain accounts from coverage under the securities laws – accounts subject to a comprehensive scheme of federal banking regulation designed to ensure financial soundness and protect depositors against the risk of insolvency, especially federal deposit insurance – the Co-Op's notes certainly do not fall within that category.

have uniformly recognized, where, as here, a debt instrument is offered to the general public in small denominations as an investment, the instrument is a security, regardless of the length of the instrument's term. See, *e.g.*, *American Bd. of Trade*, 751 F.2d at 538-540; *Hunssinger* v. *Rockford Business Credits, Inc.*, 745 F.2d 484, 492 (7th Cir. 1984); *United States* v. *Farris*, 614 F.2d 634, 641 (9th Cir. 1979), cert. denied, 447 U.S. 926 (1980); *Lawler* v. *Gilliam*, 569 F.2d 1283, 1286-1287 (4th Cir. 1978); *SEC* v. *World Radio Mission*, 544 F.2d 535, 537-540 (1st Cir. 1976); *McClure*, 497 F.2d at 493-494.

III. The Co-Op's Notes Need Not Satisfy The "Investment Contract" Test To Qualify As Securities Since They Are "Notes" Within The Statutory Definition Of Security

A. Because the Co-Op's notes fall within the term "note" in the statutory definition of security, those instruments need not also satisfy the "investment contract" test of *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946) (see note 9, *supra*). In *Landreth Timber Co.* v. *Landreth*, *supra*, the court of appeals had held that an instrument that was "stock" within the statutory definition of security nonetheless is not a security unless it satisfied the *Howey* test (471 U.S. at 685). In reversing the court of appeals' judgment, this Court squarely rejected that reasoning, explaining that the *Howey* test

> was designed to determine whether a particular instrument is an "investment contract," not whether it fits within *any* of the examples listed in the statutory definition of "security." * * * Moreover, applying the *Howey* test to traditional stock and all other types of instruments listed in the statutory definition would make the Acts' enumeration of many types of instruments superfluous.

Id. at 691-692 (emphasis in original); see *Holloway*, slip op. 19-21). As we have shown, since the Co-Op's notes were sold to the general public in small denominations as investments, they are "notes" within the statutory definition, and need not also meet the *Howey* residual test for determining coverage under the securities laws.

B. Even if the *Howey* test governed here, the court of appeals misapplied that test. First, the record shows that the Co-Op's notes were issued to and purchased by an unsophisticated public as investments. The Co-Op's self-styled "investment program" is far removed from a commercial lending arrangement. This case is thus distinguishable from *Union Nat'l Bank* v. *Farmers Bank*, 786 F.2d 881 (8th Cir. 1986), which involved a loan participation transaction between two banks. Contrary to the court of appeals' unexplained conclusion, the notes satisfy the "investment" element of the investment contract test.

Second, the court of appeals erred in concluding that the noteholders' expected return—a fixed rate of interest—may not satisfy the "profit" element of the *Howey* test. The court of appeals mistakenly relied on *Kansas State Bank* v. *Citizens Bank*, 737 F.2d 1490, 1495, (8th Cir. 1984), which in turn purported to follow *United Housing Found., Inc.* v. *Forman*, 421 U.S. 837, 852 (1975). *Kansas State Bank* focused on the *Forman* Court's discussion of "profit" to mean appreciation in value or participation in earnings. That discussion, however, describes only those types of profit considered in the Court's prior cases. Indeed, in *Forman* the Court made clear that the profit element of the *Howey* test is satisfied where "the investor is 'attracted solely by the prospects of a return' on his investment" (421 U.S. at 852)—an apt characterization of an investor's expectation of receiving interest on a debt instrument.

Furthermore, in *Howey* itself, the Court cited as an example of an investment contract falling within the securities laws the agreement in *People* v. *White*, 124 Cal. App. 548, 550-551, 12 P.2d 1078, 1079 (Dist. Ct. App. 1932), which involved a promise to return $7500 on a date certain to an investor who placed $5000 with the defendant. See *Howey*, 328 U.S. at 298 n.4. The Court viewed this agreement as one of "a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a *profit* solely through the efforts of the promoter or of some one other than themselves" (*id.* at 298 (emphasis added)).

Thus, as other courts of appeals have correctly held, a fixed rate of interest may constitute a "profit"[19] within the meaning of

the *Howey* test. See, *e.g.*, *Gary Plastic Packaging Corp.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 240-241 (2d Cir. 1985); *El Khadem* v. *Equity Securities Corp.*, 494 F.2d 1224, 1229 (9th Cir.), cert. denied, 419 U.S. 900 (1974); but see *Union Planters Nat'l Bank* v. *Commercial Credit Business Loans*, 551 F.2d 1174, 1184-1185 (6th Cir.), cert. denied, 454 U.S. 1124 (1981). And, contrary to the reasoning of the court of appeals here, excluding from the protection of the securities laws those instruments in which investors are promised a fixed return, whether in the form of interest or lump-sum payments, would be inconsistent with this Court's directive that the "statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *Howey*, 328 U.S. at 301.[20]

[19] In addition, the issuer's or seller's method of promoting an instrument is a material factor in determining whether that instrument is an investment contract. See, *e.g.*, *SEC* v. *United Benefit Life Ins. Co.*, 387 U.S. 202, 211 (1967); *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 353 (1943). Here, as discussed above (see, *e.g.*, pp. 25-26, *supra*), the record shows that the Co-Op advertised its notes as investments.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

THOMAS W. MERRILL
Deputy Solicitor General

MICHAEL R. LAZERWITZ
Assistant to the Solicitor General

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

MARTHA H. MCNEELY
Special Counsel

RANDALL W. QUINN
EVA MARIE CARNEY
Attorneys
Securities and Exchange Commission

JULY 1989

U.S. GOVERNMENT PRINTING OFFICE: 1989 — 241-000/00154

AMICUS CURIAE

BRIEF

MOTION FILED

JUL 26 1989

Supreme Court, U.S.
FILED
JUL 26 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 88-1480

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1988

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, As Representatives of a Class of Note Holders,

Petitioners,

v.

ARTHUR YOUNG & CO.

Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

[redacted]

BRIEF FOR THE ARKANSAS SECURITIES DEPARTMENT AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

John E. Moore, Jr.
Chief Counsel
Joe Madden
Arkansas Securities Department
201 East Markham, Third Floor
Little Rock, Arkansas 72201
(501) 371-1011

Attorney for Beverly Bassett
Arkansas Securities Commissioner
as Amicus Curiae

No. 88-1480

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1988

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, As Representatives of a Class of Note Holders,

Petitioners,

v.

ARTHUR YOUNG & CO.

Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

MOTION FOR LEAVE TO FILE AND BRIEF FOR THE ARKANSAS SECURITIES DEPARTMENT AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

John E. Moore, Jr.
Chief Counsel
Joe Madden
Arkansas Securities Department
201 East Markham, Third Floor
Little Rock, Arkansas 72201
(501) 371-1011

Attorney for Beverly Bassett
Arkansas Securities Commissioner
as Amicus Curiae

TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	II
ENTRY OF APPEARANCE	1
MOTION FOR LEAVE TO FILE BRIEF	2
INTEREST OF AMICUS	6
SUMMARY OF ARGUMENT	12
ARGUMENT	13
The court of appeals erred in holding that the Co-op's notes are not securities under the federal securities laws.	
CONCLUSION	26

TABLE OF AUTHORITIES

Cases	Page
Marine Bank v. Weaver, 455 U.S. 551 (1982)	14
United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975)	14
Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985)	14
SEC v. W.J. Howey Co., 328 U.S. 293 (1946)	15
SEC v. White, No. CA 86-2015 (W.D. Ark. May 1, 1986)	19
Union National Bank of Little Rock v. Farmers Bank, 786 F.2d 881 (8th Cir. 1986)	21
Hunssinger v. Rockford Business Credits, Inc., 745 F.2d 484 (7th Cir. 1984)	22
Zeller v. Bogue Electric Mfg. Corp., 476 F.2d 795 (2d. Cir. 1973)	23
Statutes	
Arkansas Securities Act, Ark. Code Ann. § 23-42-101 et seq.	2
United States Bankruptcy Code, 11 U.S.C. § 1101 et seq.	7

TABLE OF AUTHORITIES (Cont.)

Securities Act of 1933, 15 U.S.C. § 77a et seq. 13

Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq. 13

ENTRY OF APPEARANCE

Come the undersigned, John E. Moore, Jr., and Joe E. Madden, Jr., and, pursuant to Rule 28.1 of the Rules of the Supreme Court, enter their appearance as attorneys of record for Beverly Bassett, Commissioner of the Arkansas Securities Department, as amicus curiae, in this proceeding.

JOHN E. MOORE, JR.
Chief Counsel
Arkansas Securities Department
201 East Markham, Third Floor
Little Rock, Arkansas 72201
(501) 371-1011

JOE E. MADDEN, JR.
Staff Attorney
Arkansas Securities Department
201 East Markham, Third Floor
Little Rock, Arkansas 72201
(501) 371-1011

MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE

The Arkansas Securities Department moves this Court for leave to file the brief, tendered herewith, as amicus curiae in support of Petitioners in this case. Its reasons for seeking leave to appear as amicus curiae are as follows:

1. Pursuant to Ark. Code Ann. § 23-42-201, the Arkansas Securities Department is the state agency authorized and directed to administer the Arkansas Securities Act, Ark. Code Ann. § 23-42-101 et seq.

2. Pursuant to this statutory authorization, the Arkansas Securities Department regulates the issuance and sale of securities as is necessary or appropriate in the public interest or for the protection of investors.

3. The precedent established by the United States Court of Appeals for the Eighth Circuit in this case under the federal securities laws and the Arkansas Securities Act will influence the effectiveness of the Arkansas Securities Department's role in securities regulation within the State of Arkansas. The Arkansas Securities Department can provide assistance to this Court on the issues before it by providing a specific example of the impact of the Court's decision.

4. At present, there are a number of agricultural cooperatives in the State of Arkansas which issue common stock, preferred stock, promissory notes, debentures and other instruments to their members. Further, there may be other entities that have or may

contemplate the issuance and sale of instruments similar to the demand notes at issue in this case.

5. The Arkansas Securities Department clearly has an interest in the outcome of this case because the ability of the Arkansas Securities Department to administer the provisions of the Arkansas Securities Act will be significantly affected by the Court's ruling.

6. This case presents issues that are of importance to the State of Arkansas and the effectiveness of securities regulation within the State of Arkansas beyond the interest of the parties involved. The participation of the Arkansas Securities Department as amicus curiae would aid the development of the issues.

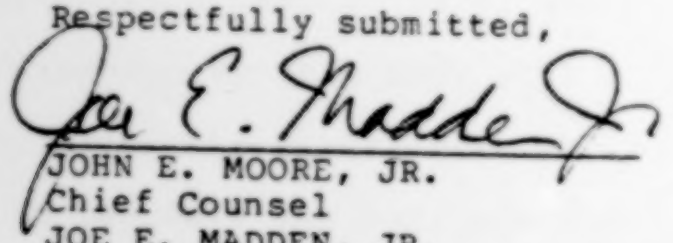
7. Whether or not to admit the amicus curiae brief to the proceeding is solely within the discretion of this Court.

8. Tendered herewith is the brief that the Arkansas Securities Department proposes to file with this court if its motion is granted. The brief is not lengthy and granting this motion would not delay these proceedings.

WHEREFORE, the Arkansas Securities Department requests that this Court grant its motion for leave to appear as amicus curiae and to file the attached brief.

Dated: July 26, 1989

Respectfully submitted,



JOHN E. MOORE, JR.
Chief Counsel
JOE E. MADDEN, JR.
Arkansas Securities Department
201 East Markham, Third Floor
Little Rock, Arkansas 72201
(501) 371-1011

INTEREST OF AMICUS CURIAE

The Arkansas Securities Department (the Department), is the agency of the State of Arkansas which is authorized and directed to administer the Arkansas Securities Act, Ark. Code Ann. § 23-42-101 et seq. (1987), pursuant to Ark. Code Ann. § 23-42-201 (1987). Among the statutory responsibilities of the Department is the regulation of the issuance and sale of securities when necessary and appropriate in the public interest and for the protection of investors.

This Court's resolution of the issues presented by this case will directly impact the Department and its ability to regulate the issuance and sale of securities in the state of Arkansas. The decision of the court

below, that the demand notes at issue are not securities under either the federal securities laws or the Arkansas Securities Act, has severely limited the Department's regulatory effectiveness.

The Farmer's Co-op of Arkansas and Oklahoma, Inc. (the Co-op) utilized a demand note program involving the wide-scale solicitation of members for the purpose of raising capital to finance the Co-op's operations. The Co-op solicited members through newsletters and advertisements comparing the Co-op's "Investment Program" to a federally insured instrument. At the time the Co-op filed for reorganization under Chapter 11 of the United States Bankruptcy code, 11 U.S.C. § 1101 et seq., approximately 1,600 individual investors held Co-op notes with a total

face value in excess of $10,000,000.00, a result comparable to a successful public offering.

The determination by the court below that these demand notes are not securities under either the federal securities laws or the Arkansas Securities Act removes this type of wide-scale solicitation of operating capital from the regulatory jurisdiction of the Department, thereby hindering its efforts to protect investors and safeguard the public interest.

As Judge Richard S. Arnold, Circuit Judge, noted in his dissent from the court of appeals' denial of the Petition for Rehearing and Rehearing en Banc, the court's holding that these notes are not securities under Arkansas law is not binding on the Department or on Arkansas state courts. (Pet. App. at A-6). Nevertheless, the court's opinion

presents a hindrance to the Department's ability to regulate this type of investment scheme under Arkansas law.

As noted by the court of appeals, the statutory definition of security is essentially the same in the Arkansas Securities Act as it is in the federal securities laws. Relying on this fact, and on federal and state court cases interpreting the Arkansas Securities Act, the court of appeals held that the notes were not securities under Arkansas law since they were not securities under the federal acts. (Pet. App. at A-24, A-25).

The legislative history of the Arkansas Securities Act, together with specific statutory provisions, clearly indicates, however, that these types of promissory notes, issued by a farm co-operative, were intended to be covered by the Arkansas act. The

Arkansas General Assembly enacted its version of the Uniform Securities Act in 1959 without an exemption for co-operatives. In 1975, 1977, and 1979, the General Assembly enacted and amended an exemption from registration for securities issued to farm co-operatives. As this exemption is presently codified, "any common stock, preferred stock, promissory note or debenture may be issued (by a farm co-operative) to any co-operative member" without registration, when certain other requirements are met. Ark. Code Ann. § 23-42-503(c) (1987) (emphasis added). As with other exemptions from registration in the Arkansas act, this provision identifies the described instruments as securities under the Act and does not exempt them from the anti-fraud provisions of the Act.

By completely ignoring the legislative history and provisions of the Arkansas act relating to farm co-operatives, the court of appeals has provided similar issuers with a means to avoid the regulatory oversight of the Department. At the very least, the court has provided such issuers with a legal opinion in conflict with the clear intent of the Arkansas Securities Act, which will significantly hinder the Department's regulatory efforts in this area. For these reasons, as well as those contained in its argument, below, the Arkansas Securities Department, as amicus curiae, urges this Court to reverse the decision of the court of appeals and reinstate the judgment of the district court below.

SUMMARY OF ARGUMENT

The United States Court of Appeals for the Eighth Circuit erred in holding that certain promissory notes issued by a farm co-operative are not securities under either the federal securities laws or the Arkansas Securities Acts. The decisions of this Court dictate that these notes are clearly securities under the federal securities laws, considering all of their characteristics and the context in which they were issued. The same conclusion must be reached whether the notes are considered under the so-called "Howey test" or under one of the other tests used by other circuits to determine when a note is a security.

ARGUMENT

THE COURT OF APPEALS ERRED IN HOLDING THAT THE CO-OP'S NOTES ARE NOT SECURITIES UNDER THE FEDERAL SECURITIES LAWS.

The Securities Act of 1933, 15 U.S.C. §77a et seq. (the 1933 Act), defines a "security" as including

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, ... or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1). The definition of "security" contained in the Securities Exchange Act of 1934, 15 U.S.C. § 78a et

seq. (the 1934 Act), is virtually identical to that contained in the 1933 Act and has consistently been treated as such by this Court. Marine Bank v. Weaver, 455 U.S. 551, 555 n.3 (1982); United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975).

This Court has stated, "It is fair to say that our cases have not been entirely clear on the proper method of analysis for determining when an instrument is a 'security.'" Landreth Timber Co. v. Landreth, 471 U.S. 681, 688 (1985). In Landreth, the Court was confronted with the sale of 100% of a business through the sale of instruments clearly denominated "stock" and concluded that "the plain meaning of the statutory definition mandates that the stock be treated as securities subject to coverage of the [1933 and 1934] Acts." 471 U.S. at 687.

While suggesting in Landreth that its analysis of the plain meaning of the statutory definition was sufficient to hold that the stocks were securities, the Court attempted to further clarify those cases in which it had looked to the economic substance of the transaction rather than just to the transaction's form to determine whether the instruments involved were securities. The Court noted that these cases, particularly SEC v. W.J. Howey Co., 328 U.S. 293 (1946), and Forman, supra, "involved unusual instruments not easily characterized as 'securities.'" 471 U.S. at 690. The Court noted further that "the Howey economic reality test was designed to determine whether a particular instrument is an 'investment contract,' not whether it fits within any of the examples listed in the statutory definition of 'security' ....

Applying the Howey test to traditional stock and all other types of instruments listed in the statutory definition would make the Acts' enumeration of many types of instruments superfluous." 471 U.S. at 691 (citations omitted)(emphasis in original).

Addressing the issue of whether other types of instruments listed in the statutory definition should be treated the same way as "stock," the Court pointed out that "note" is a "relatively broad term" encompassing "instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context." 471 U.S. at 694. The Court concluded, "We here expressly leave until another day the question whether 'notes' or 'bonds' or some other category of instrument listed in the definition

might be shown by proving [only] the document itself." 471 U.S. at 694 (brackets in original).

The United States Court of Appeals for the Eighth Circuit, applying the Howey test, held that the demand notes issued by the Co-op were not securities within the meaning of the federal acts. The court of appeals, dismissing the Landreth decision in a footnote, concluded that the notes did not bear the usual characteristics of a security and were, therefore, subject to the Howey test. The only basis for this conclusion was that, according to the court of appeals, the notes' demand feature is uncharacteristic of a security. (Pet. App. at A-20, A-21).

The court of appeals' conclusion wholly ignores the context in which these notes were issued. As noted by this Court in Landreth, a note may have

many different characteristics, depending on the context in which it is issued. These notes, despite their demand feature, were clearly issued as investments, not as consumer or commercial loans. The Co-op itself advertised the notes as an "Investment Program". (Pet. App. at A-70). Furthermore, and of particular importance to the Department, the demand notes had been considered securities subject to regulation by the Department since as early as 1975. At no time in the history of the Department's relationship with the Co-op were the notes considered non-securities. Similarly, both the SEC and the Co-op considered these demand notes to be securities under the federal securities laws, as evidenced by the SEC enforcement actions which resulted in

the entry of a consent order. See SEC v. White, No. CA 86-2015 (W.D. Ark. May 1, 1986).

As the district court accurately concluded, the facts presented in this case overwhelmingly indicate that these notes were issued in an investment context, rather than in a commerical or consumer context. The Co-op solicited its 23,000 members, as well as non-members, with a proposal that they transfer capital to the Co-op in exchange for these unsecured and uninsured demand notes. More than 1600 members purchased notes with a total face value in excess of $10,000,000.00. The demand feature of these notes alone simply does not support the court of appeals' conclusion that these instruments do not possess the characteristics of a security.

After having erroneously concluded that these notes did not possess the characteristics of a security, the court of appeals applied the Howey test to determine whether they are otherwise securities under federal law. The court of appeals determined that the demand notes represented "short-term loans with fixed interest rates which were used for operating funds." (Pet. App. at A-22). Because the Co-op initiated the investment program to obtain operating funds at rates lower than those offered by banks and because the members purchased the notes from the Co-op to earn a higher return than could be obtained from a bank, the court of appeals concluded, "Thus, ... this transaction was much more akin to a commercial lending arrangement than an investment transaction." (Pet. App. at A-22). Rejecting the district court's

careful analysis, the court held that the demand notes failed to satisfy the "investment" requirement of the Howey test.

The court offered no explanation of how the solicitation of operating capital from thousands of farmers and other unsophisticated investors even remotely resembled a commercial loan from a traditional lending institution. The court purported to rely on Union National Bank of Little Rock v. Farmers Bank, 786 F. 2d 881 (8th Cir. 1986), a case involving the sale of a participation in a commercial loan from one bank to another. There is nothing in Farmers Bank, however, that supports the court's conclusion that these unsophisticated investors were engaged in a commercial lending transaction.

As discussed above in connection with the application of Landreth to this case, the sale of the demand notes was clearly an investment on the part of the members who purchased the notes. Similarly, the Co-op advertised it as an "investment program." Although the label given to an instrument by the issuer is not dispositive, it is relevant in determining the true nature of the instrument involved. Landreth, supra; Forman, supra.

In a case involving similar circumstances, the United States Court of Appeals for the Seventh Circuit determined that the broad-scale solicitation of investors seeking a passive return on their investment, and a sale to them of units of a larger offering, are the "hallmarks of an investment transaction." Hunssinger v. Rockford Business Credits, Inc., 745

F.2d 484, 492 (7th Cir. 1984). In Hunssinger, as here, the instruments purchased were promissory notes bearing interest at a fixed rate and maturing on demand. Accordingly, the Co-op's interest bearing demand notes have all the hallmarks of an investment transaction. See also, Zeller v. Bogue Electric Mfg. Corp., 476 F.2d 795 (2d. Cir.) (Friendly, J.), cert. denied, 414 U.S. 908 (1973). The decision of the court of appeals to the contrary is not supported by either the law or the facts of this case.

The court of appeals further concluded that the Co-op's demand notes fail to satisfy the reasonable expectation of profits element of the Howey test. The court reasoned that the interest rate was fixed by an established market rate, that the

investors did not participate in the Co-op's earnings, and that there was no prospect of capital appreciation. Based on the definition of "profit" found in Forman, supra, the court of appeals concluded that the investors' expected return, as interest, did not constitute profit under the Howey test. (Pet. App. at A-22, A-23).

As the district court accurately noted, "if 'interest' is not a 'profit' within the meaning of securities [acts], then no note, bond, or debenture can ever be regulated by such statutes." (Pet. App. at A-56). "The fact that a note bears a fixed rate of interest ordinarily will be of little significance in determining whether a note is purchased as an investment or received in return for a commercial loan.... A fixed rate of interest is

simply a characteristic of the general category 'notes.'" Hunssinger, 745 F.2d at 489.

Certainly, a debt instrument is as much a security as an equity interest. In the case of debt instruments, including notes, the investor expects to receive a certain amount of interest on the capital invested together with the return of his investment at maturity. Whether the investor will actually receive these benefits is determined by the success of the business invested in. The court of appeals' broad holding that interest cannot be profit would remove all debt instruments from the coverage of the securities laws and would exclude the purchasers of such instruments from the protection of such laws. This result is at odds with the inclusion of debt instruments in the statutory definition of "security."

CONCLUSION

The United States Court of Appeals for the Eighth Circuit erroneously held that the promissory notes issued by the Co-op were not securities under either the federal securities law or the Arkansas Securities Act. The court of appeals, misconstruing this court's opinion in Landreth, determined that the notes' demand feature prevented them from having the usual characteristics of a security. Landreth clearly dictates that these instruments -- considering all of their characteristics, together with the context in which they were issued -- are securities under the federal securities laws.

Furthermore, the court of appeals erroneously applied the Howey test to these instruments and held that they were not purchased for investment and

that the return of interest on the notes could not be considered profits. Neither conclusion is supported by law or the facts of this case. Under the Howey test or any test used by other circuits to determine when a note is a security -- the commercial versus investment test, the risk capital test, or the literal test -- these notes are securities under the federal securities laws. Therefore, the decision of the court of appeals should be reversed and the judgment of the district court below should be reinstated.

Respectfully submitted,

JOHN E. MOORE, JR.
Chief Counsel
JOE E. MADDEN, JR.
Arkansas Securities Department
201 East Markham, Third Floor
Little Rock, Arkansas 72201
(501) 371-1011

CERTIFICATE OF SERVICE

I, Joe E. Madden, Jr., hereby certify that copies of the foregoing Motion and Brief have been served upon the following by depositing the same, postage prepaid, in the United States mail on this 26th day of July, 1989:

John Matson
Carl D. Liggio
Elizabeth B. Healy
Jacqueline B. Steele
Arthur Young & Company
277 Park Avenue
New York, NY 10172

Kathryn A. Oberly
2000 Pensylvania Ave., N.W.
Washington, D.C. 20006

Michael H. Mashburn
Mashburn & Taylor
P.O. Box 1921
Fayetteville, AR 72702

Gary M. Elden
John R. McCambridge
Jay R. Hoffman
Grippo & Elden
Two First National Plaza
20 South Clark Street
Suite 3000
Chicago, IL 60603
(312) 704-7700

William C. Bryson
Thomas W. Merrill
Michael R. Lazerwitz
Department of Justice
Washington, D.C. 20530

JOE E. MADDEN, JR.

AMICUS CURIAE

BRIEF

Supreme Court, U.S.
FILED
JUL 27 1989
JOSEPH F. SPANIOL, CLERK

No. 88-1480

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

BOB REVES, ROBERT H. GIBBS, AND FRANCES GRAHAM, As Representatives of a Class of Note Holders,
Petitioners

v.

ARTHUR YOUNG & CO.
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS AMICUS CURIAE

JOSEPH C. LONG
SPECIAL COUNSEL
FOR NORTH
AMERICAN SECURITIES
ADMINISTRATORS
ASSOCIATION, INC.
300 Timberdell Road
Norman, Oklahoma 73019
(405) 364-5471

Of Counsel:
LEE R. POLSON
EXECUTIVE DIRECTOR AND GENERAL COUNSEL
NORTH AMERICAN SECURITIES ADMINISTRATORS
ASSOCIATION, INC.
Suite 750
555 New Jersey Avenue, N.W.
Washington, D.C. 20001
(202) 737-0900

TABLE OF CONTENTS

	Page
TABLE OF CASES	iii
AUTHORITY TO FILE AND POSITION OF *AMICUS CURIAE*	1
STATEMENT OF THE INTEREST OF THE *AMICUS CURIAE*	1
SUMMARY OF ARGUMENT	3
ARGUMENT	6
INTRODUCTION	
I. THE EIGHTH CIRCUIT INCORRECTLY EXCLUDED DEMAND PROMISSORY NOTES FROM THE STATUTORY DEFINITION WHICH INCLUDES "ANY NOTE" AND MISCONSTRUED THE ELEMENTS OF THE HOWEY TEST FOR INVESTMENT CONTRACTS	10
A. Demand promissory notes are not a separate category within the statutory definition	11
B. The notes in the present case are also securities under Howey	12
II. NASAA URGES THE ADOPTION OF THE SECOND CIRCUIT "LITERAL APPROACH" TEST WITH MODIFICATIONS	15
A. This test should be adopted on the basis that it reflects Congressional intent rather than on "The Context Otherwise Requires" theory	17
B. Notes coupled with real or chattel mortgages are not excluded from the Act	22
CONCLUSION	30
APPENDIX	31

TABLE OF CASES

Page

Cases

American Bank & Trust Co. v. Wallace, 702 F.2d 93 (6th Cir. 1983) 16

American Bankers Ass'n v. SEC, 804 F.2d 739 (D.C. Cir. 1986) 18,21

Bauer v. Planning Group, Inc., 669 F.2d 770 (D.C. Cir. 1981) 16

Bellah v. First Nat'l Bank of Hereford, 495 F.2d 1109 (5th Cir. 1974) 15,23

C.N.S. Enters., Inc. v. G. & G. Enters., Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975) 15

Chemical Bank v. Arthur, Andersen & Co., 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984) 17,23

City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970), *aff'ing* 290 F. Supp. 592 (W.D. Ark. 1968) 8

Exchange National Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976) 5,6,16,17,22

Futura Dev. Corp. v. Centex Corp., 761 F.2d 33 (1st Cir.), *cert. denied*, 474 U.S. 850 (1985) 15

Great W. Bank & Trust Co. v. Kotz, 532 F.2d 1252 (9th Cir. 1976) 16

Holloway v. Peat, Marwick, Mitchell & Co., 1989 U.S. App. LEXIS 9807 (10th Cir. July 11, 1989) 7,8,11,12,13,18,21

Hunssinger v. Rockford Business Credits, Inc., 745 F.2d 484 (7th Cir. 1984) 13

In re Peoples Fin. & Thrift Co., 61 Cal.App.2d 11, 141 P.2d 742 (1943) 8

King Commodity v. State, 508 S.W.2d 439 (Tex. Civ. App. 1974) 23

Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) 3,5,10

Page

Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973) 15

Marine Bank v. Weaver, 455 U.S. 551 (1982) 13,23

Meason v. Bank of Miami, 652 F.2d 542 (5th Cir. 1981) 8

People v. Dempster, 396 Mich. 700, 242 N.W.2d 381 (1976) 8,23

Ruefenacht v. O'Halloran, 737 F.2d 320 (3d Cir. 1984), *affirmed sub. nom., Gould v. Ruefenacht*, 471 U.S. 701 (1985) 18

Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir. 1972), *cert. denied*, 409 U.S. 1009 (1972) 13

SEC v. American Bd. of Trade, Inc., 751 F.2d 529 (2d Cir. 1984) 12,13

SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974) 11

SEC v. Variable Annuity Ins. Co., 359 U.S. 65 (1959) 24

SEC v. W.J. Howey Co., 328 U.S. 293 (1946) 4,10,14,23

Securities Indus. Ass'n v. Board of Governors, 468 U.S. 137 (1984) 17

State v. Hoephner, 574 P.2d 1079 (Okla. Crim. 1978) 23

State v. Sheets, 94 N.M. 356, 610 P.2d 760 (App. 1980) 23

Tafflin v. Levitt, 865 F.2d 595 (4th Cir.), *cert. granted*, 109 S.Ct. 2428 (1989) 8

United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975) 4,14,16,24

Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974) 13,16

Legislative Material

H.R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933) 24

Hearings on H.R. 4314 Before the House Comm. On Interstate and Foreign Commerce, 73d Cong., 1st Sess. 11 25

Page

Statutes and Regulations

FTC Sec. Act Rel. No. 16 (July 27, 1933) 28
FTC Sec. Act Rel. No. 66 (Nov. 1, 1933) 28
Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) 17,18
Securities Act of 1933, § 3(a)(5), 15 U.S.C. § 77c(a)(5) 9
Securities Act of 1933, § 3(b), 15 U.S.C. § 77c(b) 28
Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) 27
Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) 3,10,17,18,30
Uniform Sale of Securities Act, 1929 Handbook of the National Conference of Commissioners on Uniform State Laws 173 25,26
Uniform Securities Act, § 402(b)(5), 1 Blue Sky L. Rep. (CCH) ¶ 5542 (1956) 29
Uniform Securities Act, § 402(7), 1 Blue Sky L. Rep. (CCH) ¶ 5642 (1985) 29

Miscellaneous

James, The Securities Act of 1933, 32 Mich. L. Rev. 624 (1933) 25
J. Long, Blue Sky Law § 2.03[3] (1989) 16
L. Loss, Blue Sky Law 366 (1958) 29
S. 875, *reprinted in* 1 Federal Bar Assoc., Federal Securities Laws, Legislative History at 47 27
S. Rep. No. 47, 73d Cong. 1st Sess. 4 (1933), *reprinted in* 1 Federal Bar Assoc., Federal Securities Laws, Legislative History at 92 27
Uniform Sale of Securities Act (Third Draft) § 4(j), 1927 Handbook of the National Conference of Commissioners on Uniform State Laws 26
2 L. Loss & J. Seligman, Securities Regulation 881 (3d ed. 1989) 15

No. 88-1480

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

BOB REVES, ROBERT H. GIBBS, AND FRANCES GRAHAM, As Representatives of a Class of Note Holders,

Petitioners

v.

ARTHUR YOUNG & CO.

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS AMICUS CURIAE

AUTHORITY TO FILE AND POSITION OF *AMICUS CURIAE*

This brief is filed pursuant to Rule 36.2 of the Court's Rules by written permission of the parties to the case. Such written permission is filed herewith or has been filed by the parties directly with the Court. The brief supports the position of the petitioners.

STATEMENT OF THE INTEREST OF THE *AMICUS CURIAE*

The North American Securities Administrators Association, Inc. ("NASAA") is an association of state and

provincial securities administrators in the United States, including the District of Columbia and Puerto Rico, Canada and Mexico, which, since 1918, has worked for investor protection. State securities commissioners are charged with regulating the securities markets and combatting securities frauds in their respective jurisdictions.

The dual system of federal and state regulation of securities is recognized by Section 18 of the Securities Act of 1933, 15 U.S.C. § 77r, and Section 28 of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb, which reserve the jurisdiction of state securities commissioners over any security or person. Through this dual system, the coordinated enforcement efforts of NASAA and the Securities and Exchange Commission ("SEC") have resulted in the more effective enforcement of securities fraud. The SEC concentrates in large scale enforcement actions on international or multi-state levels, with the state commissioners either serving in a back-up or assisting role in such large scale actions or concentration on more local or regional enforcement actions.

NASAA's interest in the present case is three fold. One of its member agencies, the Arkansas Securities Department has a direct interest in the litigation in that the agricultural co-operative association issuing the securities is located in Arkansas as are many of the injured investors. The Arkansas Department also has a direct interest in that the Eighth Circuit held that the definition of a "security" under the Arkansas Securities Act should be construed in the same way as the federal definition. Second, as is more fully outlined in the brief, NASAA members have had substantial enforcement problems with co-operatives similar to the one in the present case and with other unregulated financial institutions which issue notes and other similar types of evidences of indebtedness. Finally, the definition of a "security" in most current state securities statutes is based upon the federal model. The state courts, having correspondingly fewer cases construing the state acts, will often look to federal precedent, especially from this Court, as to guidance for interpreting the state act provisions. Since this is the first case where this Court will deal squarely with the issue of promissory notes as securities, NASAA wished to have its views known.

SUMMARY OF ARGUMENT

The North American Securities Administrators Association, Inc. ("NASAA") joins with the petitioners, a class of demand note holders of an Arkansas agricultural co-operative, and the SEC in urging the Court to reverse the decision of the Eighth Circuit that the demand notes purchased by the members of the class are not securities within the purview of the Arkansas and federal securities acts. NASAA submits that the Eighth Circuit must be reversed for either of two reasons. First, the Eighth Circuit did not correctly apply the legal test that it elected to adopt in the present case. Second, the Eighth Circuit adopted the wrong legal test for determining whether promissory notes are securities under the federal securities acts.

In the case at bar, the Eighth Circuit appears to have adopted a two-pronged test for determining when promissory notes are securities, based upon this Court's decision in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985). The Eighth Circuit first determined that the demand notes in question were not "notes" within that portion of the statutory definition of a "security" in Section 3(a)(10) of the Exchange Act of 1934, 15 U.S.C.

§ 78c(a)(10) which provides that "all notes" are securities. It attempted to make a distinction between "demand notes" and "notes". It then concluded that "demand notes" do not have the characteristics normally associated with securities and, therefore, are virtually never securities. NASAA submits that this analysis was error. A distinction may not be made between "notes" within the statutory definition and "demand notes". "Demand notes" are merely one form of "notes" as covered by the definition. Further, the demand feature does not always destroy the normal characteristics of a "security". This is especially true where, as in the case at bar, the demand notes are sold by an unregulated entity to members of the general public who are clearly making an investment and not engaging in a business transaction.

Concluding that the demand notes at issue were not within that portion of the statutory definition covering "all notes", the Eighth Circuit then turned to the portion of the definition covering "investment contracts" and analyzed the demand notes under the test developed by this Court in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). This test has three elements. An investment contract requires the investor (1) to invest money; (2) in a common enterprise; (3) with the expectation of a profit to come solely or substantially through the efforts of others. The Eighth Circuit concluded that the first and third elements of this test were lacking. It concluded that the purchasers of the notes had not made an investment, but entered into a commercial transaction. It also concluded that the payment of interest was not a "profit" as this Court had defined "profit" under the *Howey* test in *United Housing Foundation Inc., v. Forman*, 421 U.S. 837 (1975). Both these conclusions were error.

The note purchasers in the present case were members of the general public who were not in the business of loaning money, but rather were seeking to make a return on their investment. Likewise the agricultural cooperative association issuing the notes was not a regulated financial institution but a general business association seeking to raise the capital necessary to conduct its business. These two factors taken together indicate that the purchase of these notes constituted an investment and not the entering into of a commercial transaction. Further, the payment of interest on a debt instrument can qualify as a "profit" under the test developed in *Forman* in the same way that the payment of dividends on an equity interest does.

Second, NASAA submits that the Eighth Circuit adopted the wrong legal test for determining when promissory notes should be considered securities under the Arkansas and federal securities acts. Rather than using the two-pronged analysis based upon *Landreth, supra*, NASAA believes, as do the petitioners and the SEC, that the Eighth Circuit should have adopted the "literal approach" test developed by the Second Circuit in *Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976). Under this test, in order to avoid coverage by the securities acts, the seller of promissory notes must demonstrate that the notes sold do not bear a strong family resemblance to notes traditionally covered by the securities acts. This, the co-op in the present case cannot do. Therefore NASAA urges the Court to adopt the "literal approach " test and reverse the Eighth Circuit, re-instating the judgment of the trial court.

NASAA, however, urges the Court to base its adoption of the "literal approach" not upon the "unless the

context otherwise requires" rationale urged by the SEC, but rather on the basis that such test reflects the intent of Congress in passing the securities acts. Further, NASAA urges the Court to reject the suggestion of Judge Friendly in *Exchange National Bank*, *supra*, that transactions which result in the issuance of a promissory note coupled with either a chattel mortgage or a mortgage on a personal residence is not covered by the securities acts under the "literal approach" test. NASAA submits that such notes were clearly intended by Congress to be securities in 1933 and 1934 when it adopted the federal securities acts. The adopting of these caveats to the "literal approach" test will not alter the outcome in the present case as it is clear that the promissory notes involved here are securities under the "literal approach" test as NASAA interprets it, or any of the other presently applied tests including that developed by the Eighth Circuit. Therefore, the decision below must be reversed.

ARGUMENT

INTRODUCTION

The petitioners, the SEC, and NASAA all agree that the decision of the Eighth Circuit must be reversed. If the decision below is allowed to stand it will create a large regulatory gap in the net of protection created by the securities acts and greatly hamper the enforcement effort of both the SEC and the state securities agencies. NASAA foresees two areas of major concern. First, if the Eighth Circuit decision stands, independent trust companies, bank holding companies, Morris-Plan banks, thrift companies, consumer finance companies, small loan companies, and other similar entities which are subject to a minimum of regulation by other agencies, or

which are totally unregulated, will be able to offer demand promissory notes or pass-book savings to the general public without the customary registration and anti-fraud protection afforded by the securities acts. These entities have traditionally presented major enforcement problems for the securities commissions because of the lack of effective regulation by other state or federal agencies and because of the potential confusion by investors over the relative safety of interest bearing investments in such unregulated entities. Investors' confusion about such investments is often fostered by an absence of the disclosure which securities laws require. Many companies offering interest bearing investments similar to those sold by the farmers' co-op in this case have been involved in major fraud schemes with large loss to public investors.

The recent case of *Holloway v. Peat, Marwick, Mitchell & Co.*, 1989 U.S. App. LEXIS 9807 (10th Cir. July 11, 1989), illustrates the point. In this case, the Tenth Circuit was called upon to review the securities status of thrift certificates and pass-book accounts issued by Republic Bancorporation and its two non-bank subsidiaries, Republic Trust and Savings, a trust company, and Republic Financial Company, a finance company. All three entities were subject to either a minimum of regulation under the banking laws or were totally unregulated. Alleging both non-registration and anti-fraud violations in connection with the sale of these interests, the class action law suit sought to recover the $72.2 million lost by investors. If the Eighth Circuit decision in the present case is allowed to stand, the instruments in *Holloway* would likewise not be covered by the securities acts. Fortunately, the Tenth Circuit specifically rejected the Eighth Circuit's holding in the present case and found the instruments to be securities.

Unfortunately, the *Holloway* case is not unique in Oklahoma. Following the collapse of the Penn Square National Bank in 1981, a large number of similar suits were filed against the bank holding company controlling Penn Square and its non-bank subsidiaries alleging fraud and non-registration violations in connection with the sale of instruments similar to those in *Holloway*. Again, the sale of these instruments involved the loss of millions of dollars to investors. In all, Oklahoma had approximately ten independent trust companies similar to Republic Trust and Savings. During the last five years all but one have collapsed resulting in major losses to investors.

Nor is the Oklahoma experience an isolated one. Many states, including Nebraska, Arkansas, Michigan, and California, have had similar problems with thrift and finance companies since 1940. In each case, there have been major fraud losses to investors. *See e.g., City Nat'l Bank v. Vanderboom*, 422 F.2d 221 (8th Cir. 1970), *cert. denied*, 399 U.S. 905 (1970), *aff'ing* 290 F. Supp. 592 (W.D. Ark. 1968); *People v. Dempster*, 396 Mich. 700, 242 N.W.2d 381 (1976); *In re Peoples Fin. & Thrift Co.*, 61 Cal. App.2d 11, 141 P.2d 742 (1943). See also, *Tafflin v. Levitt*, 865 F.2d 595 (4th Cir. 1989), *cert. granted*, 109 S.Ct. 2428 (1989) (Maryland savings and loans).

Second, NASAA envisions increased problems with off-shore banks if the Eighth Circuit decision is upheld. These institutions, like their domestic counterparts, have presented major enforcement problems for securities regulators and have been the cause of substantial losses to the public through fraud. Especially troublesome have been those based in some of the islands in the Caribbean. *See e.g., Meason v. Bank of Miami*, 652 F.2d 542 (5th Cir. 1981). However, NASAA has also

noted an increase in enforcement problems from such institutions located in Micronesia and other areas of the Pacific.

Further, allowing these foreign institutions unfettered access to the American market would undermine the explicit and carefully drawn exemptions covering this type of institution found in Section 3(a)(5) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(5), and Section 402(a)(4) of the Uniform Securities Act, 1 Blue Sky L. Rep. (CCH) ¶ 5542 (1956). The federal exemption is limited to those institutions which are "supervised and examined by State or Federal authority having supervision over any such institution." The state exemption is even more narrow, exempting securities of state chartered savings and loans only if they are organized under the laws of any state and authorized to do business in this state. Under either exemption foreign savings institutions cannot qualify. Affirmance of the Eighth Circuit decision in the present case would allow foreign savings and thrift institutions unregulated access to the American Market, a concept which both Congress and the state legislatures rejected when they adopted the more restrictive domestic institutions exemption.

Assuming that the Court is in agreement with the petitioners, the SEC, and NASAA, that the Eighth Circuit decision cannot stand, the Court has a choice of how it wishes to tailor its reversal. It may take a narrow, restrictive view of the appeal. Under this approach, the Court would not review the correctness of the overall legal approach used by the Eighth Circuit in determining whether promissory notes were securities, but reverse simply on the basis that the Eighth Circuit had misapplied one or more elements of that approach in light of prior decisions of this Court. Or the Court can

take a broader approach and use this case as a vehicle to examine the issue of the appropriate test for determining when promissory notes should be considered securities under the federal securities acts.

I. THE EIGHTH CIRCUIT INCORRECTLY EXCLUDED DEMAND PROMISSORY NOTES FROM THE STATUTORY DEFINITION WHICH INCLUDES "ANY NOTE" AND MISCONSTRUED THE ELEMENTS OF THE HOWEY TEST FOR INVESTMENT CONTRACTS.

Looking at the case from the narrow view point, the Eighth Circuit, apparently based upon this Court's analysis in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), used a two-pronged test in the present case. First, it attempted to distinguish between "notes" as used in the statutory definition and "demand notes" as issued in the present case. It then concluded that demand promissory notes lack the characteristics of "notes" and, therefore, are not securities. *Reves*, 856 F.2d at 54. It then proceeded to consider whether the notes were securities under the test for investment contracts as developed by this Court in *SEC v. W.J. Howey*, 328 U.S. 293 (1946). *Howey* established a three part test for investment contracts. There must be (1) an investment of money; (2) in a common enterprise; (3) with the expectation of a profit to come solely or substantially through the efforts of others. The Eighth Circuit concluded that the notes in the present case were not investment contracts because the first and third elements of the *Howey* test were lacking. It concluded that the first element, the "investment" requirement, was missing because the Co-op note program was more akin to a commercial lending arrangement. *Id.* It also held that the third element of the *Howey* test, the

"profits" requirement, was missing because the investors did not share in the Co-op's earnings. *Reves*, 856 F.2d at 55. All three of these conclusions are incorrect.

A. Demand promissory notes are not a separate category within the statutory definition

Demand promissory notes are not distinguishable from other types of promissory notes which are within the statutory definition of a "security" found in Section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1), and Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10). It is equally clear that the demand feature of the instruments in the present case should have not effect on their status as securities. The court in *Holloway v. Peat, Marwick, Mitchell & Co.*, 1989 U.S. App. LEXIS 9807 at p.12 specifically addressed this issue and refused to accept these propositions saying:

> [T]he demand character of the passbook savings certificates is not dispositive. Although there is authority for the proposition that "a demand or short-term note is almost ipso facto not a security unless payment is dependent upon the success of a risky experience, or the parties contemplate indefinite extension of the note or perhaps conversion to stock," Kotz, 532 F.2d at 1257-58 (emphasis added), we refuse to make a talisman of this factor. As discussed above, the maturity of a note does not determine its commercial or investment character. McClure, 497 F.2d at 495; SEC v. Continental Commodities Corp., 497 F.2d 516, 524-25 (5th Cir. 1974). We doubt that Congress intended to allow the issuing entity to circumvent the securities laws solely through utilizing a short-term or demand

maturity. See SEC v. American Bd. of Trade, Inc., 751 F.2d 529, 539-40 (2d Cir. 1984).

As noted by the court in *Holloway*, the Second Circuit had taken a similar position in *SEC v. American Bd. of Trade, Inc.*, 751 F.2d 529, 539-40 where the court said:

> It is . . . unlikely that Congress meant that an issuer soliciting broad public investment in notes issued for general corporate purposes should be able to avoid the anti-fraud provisions of the 1934 Act simply by arranging that they should have "a maturity at the time of issuance of not exceeding nine months."

It is also clear as the SEC points out in its brief, that the notes in the present case are not commercial paper and, therefore, are not entitled to claim the commercial paper exclusion from the statutory definition in Section 3(a)(10) of the Exchange Act. 15 U.S.C. § 78c(a)(10). *Holloway v. Peat, Marwick, Mitchell & Co. supra* at 12-13.

B. The notes in the present case are also securities under Howey

Likewise the Eighth Circuit misinterpreted the two elements of the *Howey* test. NASAA does not believe that the consumer-commercial/investment dichotomy has any place in the determination of whether a promissory note or other instrument is an investment contract or other "security" at either the state or federal level. However, even if the Court accepts this doctrine, the case must still be reversed. No other court has applied the doctrine when a thrift institution or finance company, much less a manufacturing company or co-operative association, has made a notes or pass-book offering to members of the general public who are not engaged

in business. Other courts have all concluded that such persons were "investors" purchasing securities rather than persons engaged in a commercial transaction. *See e.g., Holloway v. Peat, Marwick, Mitchell & Co., supra; Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984); *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974); *Sanders v. John Nuveen & Co.*, 463 F.2d 1075 (7th Cir. 1972), *cert. denied*, 409 U.S. 1009 (1972).

As the court in the *Sanders* case said:

> When a prospective borrower approaches a bank for a loan and gives his note in consideration for it, the bank has purchased commercial paper. But a person who seeks to invest his money and receives a note in return for it has not purchased commercial paper in the usual sense. He has purchased a security investment.

463 F.2d at 1080, quoted with approval in *Holloway v. Peat, Marwick, Mitchell & Co., supra*, and *Zabriskie v. Lewis, supra. See also SEC v. American Bd. of Trade, Inc.*, 751 F.2d 529, 539-540 (2d Cir. 1984).

This approach is consistent with this Court's decision in *Marine Bank v. Weaver*, 455 U.S. 551 (1982), that certain certificates of deposit and pass-book accounts issued by federally regulated banks were not securities because of the adequate regulation provided under the federal banking acts. Such analysis would not have been necessary had the Court felt that demand notes and pass-book accounts were not securities in the first place because they involved commercial transactions. Therefore, even if the commercial/consumer dichotomy is accepted, the first element of the *Howey* test is met. The purchasers of the Co-op's notes have made an investment.

The Eighth Circuit also misinterpreted the "profits" element of the *Howey* test. This Court has defined "profits" under the *Howey* test as meaning either capital appreciation on the investment or the payment of consideration, normally in the form of money, for the use of the investor's money. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975). However, the requirement of *Howey* is that the investor be induced to make his investment *based upon his expectation that he will receive a "profit"* as defined. There is no requirement that the entity in which the investor invests must make a profit or that the investor share in that profit. As a result, the payment of interest promised on a debt security for the use of the money can constitute a profit. There is no difference between the payment of interest on a debt interest and the payment of dividends on an equity security.

The Petitioners in this case clearly intended to profit from the receipt of interest, and they expected their profit to exceed the return available from insured deposits at savings institutions. The Eighth Circuit noted that investors in the notes were promised higher interest rates than could be obtained from area banks or savings and loans. *Reves*, at 55. Promoters using the same scheme as the sellers in this case often promise better returns on investments than can be had at local financial institutions. The reason rates were higher was because risk was higher. Risk is a primary determinate in interest rate differentials. Investors risked their money to obtain a profit greater than the return available from federally insured deposits.

II. NASAA URGES THE ADOPTION OF THE SECOND CIRCUIT "LITERAL APPROACH" TEST WITH MODIFICATIONS

Turning to the broader view, NASAA believes that the Court has granted certiorari in the present case to establish the test to be used in determining when promissory notes are securities. As the petitioners and the SEC have pointed out, there appear to be three tests in use by the various Courts of Appeal. It is arguable that the Eighth Circuit in the present case created yet a fourth test. The three traditional tests in use prior to the present case are: (1) the commercial-consumer/ investment dichotomy test; (2) the risk capital test; and (3) the "literal" approach test.

As explained by Professor Loss in his treatise on securities, the commercial-consumer/investment dichotomy is designed to eliminate both commercial and consumer transactions from coverage under the securities acts on the theory that Congress intended the federal securities acts to cover only investment transactions. 2 L. Loss & J. Seligman, Securities Regulation 881 (3d ed. 1989). This is done on a case by case basis by weighing a number of factors to determine whether the transaction involved is a consumer or commercial one which will not be covered by the securities acts or an investment one which will. Professor Loss reports that this test has been adopted by the First, Third, Fifth, Seventh and Tenth Circuits. *Id.* citing among others: *Futura Dev. Corp. v. Centex Corp.*, 761 F.2d 33 (1st Cir. 1985), *cert. denied*, 474 U.S. 850 (1985); *Lino v. City Investing Co.*, 487 F.2d 689 (3d Cir. 1973); *Bellah v. First Nat'l Bank of Hereford*, 495 F.2d 1109 (5th Cir. 1974); *C.N.S. Enters., Inc. v. G. & G. Enters., Inc.*, 508 F.2d 1354

(7th Cir.), *cert. denied*, 423 U.S. 825 (1975); *Zabriskie v. Lewis*, 507 F.2d 546 (10th Cir. 1974).

The risk capital test which has been adopted only in the Sixth and Ninth Circuit, *see e.g., American Bank & Trust Co. v. Wallace*, 702 F.2d 93 (6th Cir. 1983); and *Great W. Bank & Trust Co. v. Kotz*, 532 F.2d 1252 (9th Cir. 1976), uses a weighing test similar to that used in the commercial-consumer/investment test to determine whether an investment is made in the risk capital of an enterprise. This test is extensively used at the state level as an alternative test for "investment contracts." *See* J. Long, Blue Sky Law § 2.03[3] (1989). This Court noted the risk capital test as an alternative test for "investment contracts" in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 857, N.24 (1975), but refused to adopt it.

In the present case as noted above, the Eighth Circuit appears to adopt still a fourth test. This test first asks the question whether notes at issue possess the characteristics common to other promissory notes covered by the securities act. If not, then the instruments must be measured by the *Howey* test for investment contracts. If the note in question meets either prong of the test it is a security. If it meets neither test, it is excluded from coverage. This test finds some support in the District of Columbia Circuit decision in *Bauer v. Planning Group, Inc.*, 669 F.2d 770 (D.C. Cir. 1981).

NASAA submits that all three of the above outlined tests are seriously flawed and should not be adopted. Therefore, NASAA joins with both the petitioners and the SEC in urging the Court to adopt the Second Circuit "literal" approach test developed by Judge Friendly in *Exchange National Bank of Chicago v. Touche Ross & Co.*,

544 F.2d 1126 (2d Cir. 1976). *See also Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984). Under this test, promissory notes are to be considered securities unless the defendant can establish that the notes at issue do not bear a strong family resemblance to those covered by the securities act. *Exchange National Bank*, 544 F.2d at 1138. This test places the burden of proof on the defendant to establish that an instrument in any given case is unlike promissory notes intended to be covered by the securities acts and, therefore, outside their purview. The adoption of this "literal" approach finds support by this Court's opinion in *Securities Indus. Ass'n v. Board of Governors*, 468 U.S. 137, 153 (1984), where the Court used it to define a note in the context of the Banking Act of 1933.

NASAA, however, does not support the rationale used by Judge Friendly to support this test or his suggested exclusions from the coverage of the acts. NASAA believes that the rationale used to support the test is built upon a false premise. Further, the suggested exclusions are based upon an incorrect assumption as to the intended coverage of the acts.

A. This test should be adopted on the basis that it reflects congressional intent rather than on "the context otherwise requires" theory

The problem faced by Judge Friendly and the Court in the present case is that the definitional sections of both the 1933 Securities Act and the 1934 Exchange Act, Sections 2(1) and 3(a)(10), 15 U.S.C.§ 77b(1) and 15 U.S.C. § 78c(a)(10) respectively, specifically include "all notes". Therefore, some rationale must be developed to justify a departure from a literal reading of the

statutory language which would bring all promissory notes within the purview of the securities acts. Judge Friendly elected to seize upon the introductory language to both Sections 2 and 3(a) which states: "When used in this title, *unless the context otherwise requires* — ". *Emphasis added.* He used this clause to modify the statutory language defining a "security" to exclude certain types of promissory notes which he felt should not be covered by the securities act. Judge Friendly is not alone in the urging of this rationale. The SEC urged this approach in its brief in *Marine Bank v. Weaver*, 455 U.S. 551 (1982) and again in its brief in the present case.

NASAA, however, joins with the Third and District of Columbia Circuits in urging the Court not to adopt this rationale. *See American Bankers Ass'n v. SEC*, 804 F.2d 739 (D.C. Cir. 1986); *Ruefenacht v. O'Halloran*, 737 F.2d 320 (3d Cir. 1984), *affirmed sub. nom., Gould v. Ruefenacht*, 471 U.S. 701 (1985). *See also Holloway v. Peat, Marwick, Mitchell & Co.*, 1989 U.S. App. LEXIS 9807 (10th Cir. July 11, 1989). Judge Gibbons, NASAA submits, correctly pointed out the fallacy of the "unless the context otherwise requires" justification when he said in *Ruefenacht*:

> Perhaps the most notable feature about the "context clauses" is that they do not appear in the paragraphs defining "security" at all. Instead, these clauses precede all fifteen definitions in the 1933 Act and all forty definitions in the 1934 Act. Plainly, the "context clauses" were not directed particularly at the definition of "security." This lack of particular application is underscored by the legislative history of the definitions of "security." In neither the House nor the Senate reports, for example, did the drafters allude to the clauses or indicate that

particular kinds of stock, notes, or debentures are embraced by the Act "only when the context requires." If the drafters had indeed intended that the context clause exempted certain named securities from coverage, they certainly made no mention of it.

The legislative evolution of the 1933 Act suggests even more strongly that the context clauses had no such purport. Section 2 of the Senate version of the 1933 Act provided, "When used in this Act the following terms shall, unless the text otherwise indicates, include the following respective meanings." H.R. 5480, 73d Cong., 1st Sess. 39 (1933) (emphasis added) (as enacted by the Senate on May 10, 1933); S. 875, 73d Cong., 1st Sess. 1 (1933). This Senate bill tracked the language of an early House bill, H.R. 4314, which had also opened with the phrase, "unless the text otherwise indicates." H.R. 4314, 73 Cong., 1st Sess. 2 (1933). Early in the legislative process, however, the House Committee substituted the language "unless the text otherwise indicates." See H.R. 5480, 73d Cong., 1st Sess. 1 (1933) (as enacted by the House on May 5, 1933). Ultimately the Conference Committee adopted the House version. Although the Conference Committee Report discusses a number of significant distinctions between the House and Senate definitions, the Report makes no mention of the difference between these prefatory clauses. See H.Conf.Rep. No. 152, 73d Cong., 1st Sess. 24-25 (1933).

It seems that the drafters did not attribute particular significance to the distinction between these House and Senate phrases. The "text" to which the Senate had adverted was obviously the text of the

statute itself. Similarly, the "context" to which the House referred was obviously the context in which the defined words appear in the statute itself. Both the House and Senate provisions were intended to direct that the ensuing definitions were to be used throughout the statute unless the text of the Act expressly, or another section of the statute implicitly, made them inapplicable to that section.

The defendants, however, would have us attribute a very different meaning to the "context" language. That language, they assert, refers not only to the statutory context but to the context of the underlying factual transaction. Thus, they argue, the House and Senate versions of the 1933 Act had very different meanings. The Senate version, of course, would not have admitted of the defendants' interpretation, for it would have authorized exceptions as "the text otherwise indicates," not as the factual circumstances seem to warrant. The House version, in contrast, as the defendants construe it, sanctioned a wide-ranging exemption power varying with the facts and circumstances. It strikes us that if the conferees had observed so considerable a distinction between the House and Senate bills and had selected the broader, House versions, they would at least have remarked upon so important a subject. Moreover, a wide-ranging exemption power is inconsistent with the Act's conferral of exemption power on the SEC. Because the Act conferred a narrowly tailored exemption power on the Commission, it seems extraordinary that the conferees should not have remarked upon a potentially broader power through the context clause.

> These considerations lead us to conclude that the context clauses themselves do not authorize judicial exclusions of securities from the scope of the Act when the "factual circumstances" seem to warrant it. . . . We . . . observe that Congress did not intend the context clause as a font of authority. . . .

737 F.2d at 330-331. Footnotes omitted.

The District of Columbia Circuit also has rejected the "context" argument saying:

> First and foremost, we do not accept the major premise of the SEC's context clause argument: that the phrase "unless the context otherwise requires" refers to out-of-Act market or regulatory circumstances as well as intra-Act textual contexts. We read the context clause as meaning only that if in the case of a frequently occurring statutory term, its immediate context suggests that a literal application of the statutory definition would produce absurd consequences or run counter to the obvious thrust of the section, the agency may appropriately modify the definition. . . . We are convinced. . . that the context clause does not confer such broad license upon courts and the SEC to *change basic decisions made by Congress*.

American Bankers Ass'n v. SEC, 804 F.2d at 753-754. *Emphasis added.* Most recently, the Tenth Circuit reemphasized this last point saying that the context of the underlying transaction cannot be used to contradict the intent of Congress as contained in the legislative history and structure of the securities acts. *Holloway v. Peat, Marwick, Mitchell & Co., supra* at 11.

NASAA submits that the only justification for the departure from the strict construction of the statutory language lies in a determination that Congress did not intend to include the items excluded within the statutory definition. Even then as Judge Friendly stated in *Exchange National Bank*:

> So long as the statutes remain as they have for over forty years, courts had better not depart from their words without strong support for the conviction that . . . they are doing what Congress wanted when they refuse to do what it said.

Exchange National Bank, 544 F.2d at 1138.

B. Notes coupled with real or chattel mortgages are not excluded from the Act

Unfortunately Judge Friendly did not follow his own admonition when he outlined in *Exchange National Bank* those items which he felt were clearly excluded from the category of "notes" for the purposes of the securities acts. He gave the following examples of notes which were not intended to be covered:

> [T]he note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business . . . .

544 F.2d at 1138. However, Judge Friendly did not explain or cite any authority indicating that Congress intended to exclude these items from coverage of the

acts, he merely *assumed* such to be the case[1]. Nor did he add further light to this assumption when he revisited the area in *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984).

NASAA believes that many of Judge Friendly's examples are securities within the purview of the securities acts as intended by Congress in 1933 and 1934. A careful

---

[1] In fairness to Judge Friendly this is an assumption that is shared by many lawyers, courts, and even to a limited extent by the SEC. Thus Judge Gewin in *Bellah v. First Nat'l Bank of Hereford*, 495 F.2d 1109, 1114 (5th Cir. 1974), the seminal case holding that not all promissory notes were securities expressed doubt that Congress intended the securities laws "to render federal judges the guardians of all beguiled makers or payees". A similar statement was made by this Court in *Marine Bank v. Weaver*, 455 U.S. 551, 556 N.10 (1982).

This misconception stems from the fairly widely held view that the federal securities laws was intended to deal largely, if not exclusively, with the more regular securities such as stocks, bonds, debentures, and other similar items which are traded on the major exchanges or in the over-the-counter market. Such is clearly not the case as this Court's decision in *SEC v. W.J. Howey*, 328 U.S. 293 (1946), makes abundantly clear. The federal securities acts were patterned extensively upon the state securities laws which preceded them. State securities agencies, especially their enforcement staffs, then as now, spend the largest part of their time dealing with "exotic" or irregular securities and fraud schemes involving all types of unusual promissory notes and evidences of indebtedness. See e.g., *State v. Sheets*, 94 N.M. 356, 610 P.2d 760 (App. 1980); *People v. Dempster*, 396 Mich. 700, 242 N.W.2d 381 (1976); *State v. Hoephner*, 574 P.2d 1079 (Okla. Crim. 1978); *King Commodity v. State*, 508 S.W.2d 439 (Tex. Civ. App. 1974). Therefore to NASAA and its member state agencies it is vitally important that this Court recognize and understand the wide sweep that Congress, based upon the previous state law experience, intended for the securities acts and the definition of a "security".

review of the legislative history of the Acts and state blue sky experience before their enactment must be made before any item can be excluded simply on the basis of intuition or present feeling or experience. As Justice Brennan said in his concurring opinion in *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 76 (1959) (Brennan, J., concurring), the definitions and the functional scheme of the Acts are to be measured by Congressional intent in 1933 and 1934 when the Acts were passed and not by developments which have taken place since that time.

Further, concerning Congressional intent as to the definition of a security, this Court said in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837,847-848 (1975):

> In providing [the] definition [of a security] Congress did not attempt to articulate the relevant economic criteria for distinguishing "securities from "nonsecurities." Rather it sought to define "the term 'security' so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."

Citing H.R. Rep. No 85, 73d Cong., 1st Sess., 11 (1933).

Thus, the issue NASAA believes is whether Congress believed in 1933 or 1934 that any of the items Judge Friendly *assumed to be excluded* from the coverage of the securities act were securities within its purview. Based upon its review of the legislative history and surrounding information NASAA believes that consumer transactions to the extent that they result in the issuance of a promissory note coupled with a chattel mortgage and a note coupled with a mortgage on a personal dwelling were considered by Congress to be

securities in 1933 and 1934 and were intended to be covered by the securities acts.

The obvious starting point to verify this conclusion is the legislative history of the acts themselves. It has been acknowledged that the definition of a "security" in the 1933 Act was taken from the earlier Uniform Sale of Securities Act adopted in 1929. *See* James, The Securities Act of 1933, 32 Mich. L. Rev. 624, 631 (1933). For the text of the Uniform Act, *see* 1929 Handbook of the National Conference of Commissioners on Uniform State Laws 173 ("Handbook"). In actual fact, the reliance on the Uniform Sale of Securities Act was much greater than simply the borrowing of the definitions. Huston Thompson, one of the principal draftsmen of the 1933 Act, in his testimony before the House, indicated that the original Senate version of the 1933 Act, S. 875, was based in large measure on the Uniform Sale of Securities Act. Remarks of Huston Thompson, Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 11. A comparison of the S. 875 and the Uniform Sale of Securities Act confirms this statement.

These two facts are of major significance because the Uniform Sale of Securities Act contained an exemption for notes and mortgages on *real estate or tangible personal property*. Section 5(g) of the Uniform Act provided a securities exemption for:

> Bonds or notes secured by mortgage upon *real estate or tangible personal property* where the entire mortgage together with all of the bonds or notes secured thereby are sold to a single purchaser at a single sale.

1929 Handbook at 182. *Emphasis added.* Even more revealing is the Third Draft of the Uniform Sale of Securities Act published in 1927. This draft contained an exemption in Section 5(g) identical to Section 5(g) quoted above. In addition, it contained an exemption for:

> Securities evidencing indebtedness due under any contract made pursuant to the provisions of any statute of any state of the United States providing for the acquisition of personal property under conditional sales contract.

Uniform Sale of Securities Act (Third Draft) § 4(j), 1927 Handbook. This is a clear indication that as of 1927 consumer transactions resulting from the installment sale of goods were considered securities, albeit securities exempt from the registration requirement (but not the anti-fraud provisions, see Section 15, 1929 Handbook).

These Uniform Sale of Securities Act provisions are not unique. Most states securities acts dating from at least 1915 had similar provisions exempting notes supported by either real property mortgages or personal property mortgages or both. See e.g., Mich. Act No. 46, P.A. 1915, § 3(f); Miss. Laws 1916, Ch. 97 § 12(d); S.C.Laws 1915, Ch. 160, § 2(f). *See generally*, J. Elliott, The Annotated Blue Sky Laws of the United States (1919) collecting the state statutes and interpretations thereof as of 1919. Often the note and mortgage exclusion covered only property located in the state, meaning that notes and mortgages on property located outside the state would be subject to full registration. See e.g., Ark. Laws 1915, Act 242, § 3(f); Idaho Laws 1913, Ch. 117, § 1.

With this background of treating notes coupled with real and personal property mortgages as securities at the state level prior to 1933, it is not surprising that the original Senate version of the 1933 Act had a similar provision. Section 11(d) of the original version of S. 875 created a securities exemption for:

> Bonds or notes secured by mortgage upon real estate, improved or about to be improved by a *residential structure*, when the total encumbrances against any single property so mortgaged including the mortgage securing the bond and notes exempted by this paragraph do not exceed $25,000.

Reprinted in 1 Federal Bar Assoc., Federal Securities Laws, Legislative History at 47 ("Legislative History"). The Senate Judiciary Committee substitute bill S. 875 contained the same exemption except the amount was raised to $50,000. Legislative History at 79. The Senate Report on this portion of the bill indicates that it created an exemption for "real estate bonds and notes on residential property not exceeding $50,000." S. Rep. No. 47, 73d Cong. 1st Sess. 4 (1933), *reprinted in* Legislative History at 92.

As is well known, the Senate version of the 1933 Act was not adopted in favor of the House counterpart. The House bill does not have any exemption for bonds and notes secured by real property mortgages. As far as the original negotiation of these notes and mortgages is concerned this omission was not significant because the House version had the private placement exemption which is now Section 4(2), 15 U.S.C. § 77d(2), not contained in the Senate bill. Certainly this private placement exemption would cover the original negotiation of a note covered by either a real or personal

property mortgage to a bank, insurance company, or other financial institution. Therefore registration of the negotiation would not be required.

Almost immediately after the passage of the 1933 Act, the FTC, which administered the 1933 Act for the first year, adopted a Rule under the discretionary exemption provision of Section 3(b), 15 U.S.C. § 77c(b), covering residential real property notes and mortgages. FTC Sec. Act Rel. No. 16 (July 27, 1933), reprinted in the Appendix to this Brief. This was replaced in November of 1933 by a new Rule covering notes and bonds comprising an issue in the aggregate not exceeding $15,000 secured by a first mortgage or deed of trust on real estate or long term lease on which there is a dwelling for no more than four families, *one of which must be that of the issuer*. FTC Sec Act Rel. No. 66 (Nov. 1, 1933), reprinted in the Appendix to this Brief. After the SEC took over administration of the Act, it, in 1938 replaced the FTC Rule with two new Rules, Rules 203 and 209, former 17 C.F.R §§ 230.203 and 230.209 (1938). These Rules later evolved into SEC Regulation A-R and finally into SEC Rule 234, former 17 C.F.R. § 230.234 (1961). Rule 234 remained in effect until withdrawn in 1982. Thus, from the inception of the 1933 Act until 1982, it was clear that notes on residential real property were securities within the Act, but exempt from registration (but not the anti-fraud provisions of Sections 12(2) and 17(a), 15 U.S.C. 77l(2) and 77q(a)).

The same was true at the state level. When the Uniform Commissioners published the Uniform Securities Act in 1956, Professor Loss, the primary draftsman

of the act elected to retain as the Section 402(b)(5) transactional exemption:

> any transaction in a bond or other evidence of indebtedness secured by a real or chattel mortgage or deed of trust, by an agreement for the *sale of real or chattels*, if the entire mortgage, deed of trust, or agreement, together with all the bonds or other evidences of indebtedness secured thereby, is offered and sold as a unit;

Uniform Securities Act, § 402(b)(5), 1 Blue Sky L. Rep. (CCH) ¶5542 (1956). The Draftsmen's Commentary states that: "This exemption is standard in substance." L. Loss, Blue Sky Law 366 (1958). Thirty-nine state jurisdictions have adopted the Uniform Act. 1 Blue Sky L. Rep. (CCH) ¶5500 (1989). This exemption was also carried forward into the new Uniform Securities Act (1985) § 402(7), 1 Blue Sky L. Rep. (CCH) ¶5642 (1985) without substantive change.

The above discussion shows that for more than seventy years notes covering both real and chattel mortgages have been treated as securities at the state and federal level. In light of this experience, NASAA cannot accept the unsupported conclusion by Judge Friendly that notes issued in consumer transactions and notes secured by a home mortgage are not securities.

Similar review of other items that Judge Friendly would assume excluded shows that the assumption is unwarranted. Therefore, while NASAA urges the Court to accept the "literal approach" test, it urges the Court to carefully examine the legislative history and previous blue sky experience before determining that a particular type of promissory note was not intended by Congress to be covered under the securities acts. At the same

time, acceptance of the NASAA limitations on the scope of the "literal approach" test will have no impact on the present case. The notes before the Court as the SEC clearly establishes in its Brief are not within the statutory exclusion for commercial paper found in Section 3(a)(10) of the Exchange Act, 15 U.S.C. § 78c(a)(10). They are typical investment-type promissory notes which should be included within the protection of the securities act under the NASAA proposed modified "literal approach" test or any other presently recognized test.

CONCLUSION

Based upon the above reasoning and cases cited, NASAA urges the Court to adopt the modified "literal approach" test for determining when promissory notes will be considered securities under the federal securities acts. NASAA, therefore, urges the Court to reverse the decision of the Eighth Circuit below and reinstate the judgment of the trial court.

Respectfully submitted,

JOSEPH C. LONG
SPECIAL COUNSEL FOR THE
NORTH AMERICAN
ADMINISTRATORS
ASSOCIATION, INC.
300 Timberdell Road
Norman, Oklahoma 73019
(405) 364-5471

APPENDIX

For IMMEDIATE Release, Thursday, July 27, 1933.

FEDERAL TRADE COMMISSION
Washington

SECURITIES ACT OF 1933
Release No. 16

NOTES AND BONDS SECURED BY REAL ESTATE MORTGAGES ARE EXEMPTED.

The Federal Trade Commission today adopted a rule exempting from the requirements of registration under the Securities Act of 1933 certain securities regarding which enforcement of the registration provisions does not appear to be necessary in the public interest nor for the protection of investors, because of the small amounts involved and the limited character of the public offering.

These exemptions are made under authority of Section 3(b) of the Securities Act providing that the Commission may add any class of securities to those exempted by the act if it finds that enforcement of the act with respect to such securities is not necessary in the public interest and for protection of investors.

The exempted securities are notes or bonds directly secured by first mortgage or deed of trust on a contiguous plot of real estate or on a leasehold which is other than for oil, gas or mining.

Two classes of such securities are designated as follows:

First, there is the transaction where the entire mortgage or deed of trust is transferred with the entire

account of notes or bonds to a single purchaser at a single sale.

Second, there is the transaction where the notes or bonds secured by the mortgage or deed of trust are transferred to more than one person in more than one sale, the number of notes or bonds so secured not to exceed 25.

Various conditions and requirements regarding transactions in either class are stated specifically in the Commission's ruling, full text of which is as follows:

NOTES AND BONDS SECURED BY REAL ESTATE MORTGAGES

The Federal Trade Commission in pursuance of the authority conferred upon it by the Securities Act of 1933, finding that the enforcement of the Act with respect to the following securities does not appear to be necessary in the public interest and for the protection of investors by reason of the small amount involved and the limited character of the public offering, exempts the following securities from the requirement for registration when offered, sold, extended, renewed, or exchanged to the public under the conditions herein described.

(1) Notes or bonds directly secured by first mortgage (or deed of trust) on a contiguous plot of real estate, or a leasehold (other than oil, gas or mining leasehold), when the entire mortgage (or deed of trust) is transferred together with the entire amount of notes or bonds to a single purchaser at a single sale, if (a) neither the face value nor the offering price of such notes or bonds exceeds $100,000; (b) if the commissions, discounts, brokerage changes, and all other expenses to the

borrower for procuring the loan do not exceed a total of five percentum of the face value of the loan; (c) if, in the case of a construction mortgage, the notes or bonds are plainly stamped or inscribed with a statement that the security underlying them is of the nature of a construction mortgage, subject to prior mechanics', materialmens' and similar liens (the character of such similar liens being specifically described); and (d) the aggregate face value of such notes or bonds (not including interest rates or coupons) secured by such mortgages (or deed of trust) does not exceed sixty-five percentum of the fair market value of the real property or leasehold on the date of the issue of such securities.

(2) Notes or bonds directly secured by first mortgage (or deed of trust) on a contiguous plot of real estate or leasehold (other than oil, gas or mining leasehold) if (a) neither the face value of the offering price of such notes or bonds exceeds $60,000; (b) if the real estate is not further removed from the residence or place of business of the purchaser of the notes than one hundred and fifty miles; (c) if the entire number of the notes or bonds secured by the mortgage or deed of trust is not in excess of twenty-five; (d) if the commissions, discounts, brokerage charges and all other expenses to the borrower for procuring the loan do not exceed a total of five percentum of the face value of the loan; (e) if in the case of a construction mortgage the notes or bonds are plainly stamped with a statement that the security underlying them is of the nature of a construction mortgage, subject to prior mechanics', materialmens', and similar liens (the character of such similar liens being specifically described); (f) if the aggregate face value of such notes or bonds (not including interest notes or coupons) secured by such mortgage (or deed of trust) does not exceed sixty-five percentum of the fair market

value of the real property or leasehold on the date of the issue of such securities; (g) if the person offering such notes or bonds to the public is not controlled by or pecuniarily interested in, by way of stock ownership or otherwise, the trustee (or person performing similar functions under the mortgage (or deed of trust), and such trustee or other person is not similarly controlled by or pecuniarily interested in the person offering such notes to the public; and (h) if the person offering the notes or bonds to the public shall at the time of their sale give the purchasers a written statement briefly setting forth, and shall in all prospectuses dealing with such notes or bonds, briefly set forth, (i) the person or person who have examined the title to the underlying property; (ii) the total amount of the notes or bonds authorized under the terms of the mortgage (or deed of trust); (iii) the assessed value of the underlying property as of the time of the sale of such notes or bonds and the value for which it was appraised in connection with the mortgage (or deed of trust) under which such notes are issued; (iv) the aggregate taxes assessed against the underlying property for the year prior to the time of the sale of such notes or bonds, together with a statement of any special assessments that may have been made against such property but remain unpaid; (v) the rights of the note holder or bondholder upon default in payment of the interest or any amortized payment; (vi) a description of the underlying property, identifying it and stating the purposes for which it is to be used; (vii) the amount of insurance outstanding upon the underlying property, its character and the obligations of the mortgagor to maintain the insurance; (viii) the nature of the amortization provisions, if any; and (ix) the amount of commissions received or to be

received by the person controlled or affiliated with him, for effecting such sale, extension, renewal, or exchange.

Neither of the above exemptions shall apply to any such note or bond where the payment of the principal or interest thereof is guaranteed by some person other than issuer, unless such guarantor shall have filed a registration statement in the form prescribed by the Commission, and a prospectus based upon such registration statement is furnished to the purchaser at the time of sale.

For IMMEDIATE RELEASE, Wednesday, November 1, 1933.

FEDERAL TRADE COMMISSION
Washington

SECURITIES ACT OF 1933
Release No. 66

The Federal Trade Commission today announces its repeal of a rule promulgated July 27, (Release No. 16) regarding exemption from registration under the Securities Act of certain classes of real estate mortgages. In its place, it announced a new rule applicable not only to small issues consisting of notes and bonds directly secured by first mortgage on real estate but also to any issue the aggregate offering price of which is under $100,000, providing that the issue fails within certain prescribed conditions.

The issues exempted by the new rule can be described as follows:

1. Notes and bonds comprising an issue the aggregate amount of which does not exceed 615,000 which are directly secured by first mortgage or first

deed of trust on a piece of real estate used as the issuer's home.

2. Securities of any character comprising an issue the aggregate amount of which does not exceed $100,000, subject to the following prescribed conditions:

(a) That the issue shall not be sold otherwise than for cash;

(b) That no other securities shall have been issued by the same issuer in excess of $100,000, including the issue now to be offered, within the year immediately preceding the issue;

(c) That no other securities of the same class shall have been issued within the year immediately preceding for any other consideration than cash;

(d) That the commission charged in connection with the distribution of the issue shall not exceed 10% of the offering price;

(e) That the issue, if bonds, shall not be divided into units less than 3500, and if stocks, into units less than 3100, and if any other type of security, into units less than 2500;

(f) That if the issue consists of notes or bonds secured by first mortgage on real estate, the issue will also be exempt even if divided into small units than 3500, provided that a prospectus containing detailed information be furnished to the purchaser.

3. The third class of securities exempt by this regulation comprises issues which are exchanged

for other outstanding securities, including in such terms extensions or renewals of outstanding obligations. These issues are exempted when the par value of the securities to be exchanged does not exceed $100,000. A prospectus containing a brief summary of the terms upon which the exchange is to be effected is to be furnished to each person to whom securities are sought to be exchange for a new security.

Full text of the new rule is as follows:

Exemption of issues Whose Aggregate Amount Does Not Exceed $100,000

The Federal Trade Commission, in pursuance of the authority conferred upon it by the Securities Act of 1933, finding that registration under the Act with respect to the following securities does not appear to be necessary in the public interest and for the protection of investors by reason of the small amount involved and the limited character of the public offering, exempts from the requirements for registration securities of the following classes:

I. — Notes and bonds comprising an issue the aggregate amount of which does not exceed $15,000, directly secured by first mortgage or first deed of trust on real estate or on a leasehold under a renewable lease for not less than ninety-nine years (or such first mortgages or first deeds of trust on such real estate or leasehold), upon which there is located a dwelling for not more than four families occupied in whole or in part by the issuer as a home.

II. — Securities (other than securities representing a fractional undivided interest in oil, gas, or mining rights) comprising an issue no portion of which is to be

issued otherwise than for cash, which comply with the following conditions:

1. That no securities of the same class as those herein exempted have been sold otherwise than for cash within one year prior to the date of the public offering of the securities herein exempted.

2. That the aggregate amount (being the product of the number of units offered and the price per unit at which they are offered) at which the securities herein exempted are offered to the public does not exceed $100,000, exclusive of accrued interest and/or dividends. In case the securities are offered at the market, the aggregate amount at which the securities herein exempted are offered to the public shall be determined by the above method save that the average price per unit at which the securities are bona fide sold on the first day shall be regarded as the price per unit at which the securities were offered.

3. That the net proceeds, after deduction of all expenses of distribution, realized by the issuer from all other securities, except such as are described in Section 3(a)(3), issued by such issuer, within one year prior to the offering of the securities herein exempted, together with the net proceeds to be realized from the issue herein exempted, shall not exceed $100,000.

4. That if distribution be effected through an underwriter the net proceeds, after deduction of all expenses of distribution, to be realized by the issuer from the securities herein exempted be not less than 90% of the aggregate amount at which the securities herein exempted are offered to the pub-

lic, calculated in accordance with paragraph (2) above.

5. That if the securities be bonds or other evidences of indebtedness, except as provided in paragraph (6) and section I hereof, they be in denominations of a face value of not less than $500.00; if shares of stock, the par or stated value per share be not less than $100.00; if any other kind of security, the offering price thereof per unit be not less than $500.00

6. That is the securities be notes or bonds directly secured by first mortgage or first deed of trust on real estate or on a leasehold (other than oil, gas or mining leaseholds, provided that the grant of a right to remove oil, gas or minerals shall not limit the exemption with reference to the first mortgage on the surface) or be such first mortgage or first deed of trust, that such securities also shall be exempted even though they be in denominations of a face value less than $500.00 but not less than $50.00. But no person who sells any security exempted by virtue of this paragraph shall be immune from the liabilities imposed upon such person if the security were not so exempted, unless such person shall prior to the time of such sale give the purchaser (unless such purchaser be a financial institution or insurance company and be under state or federal supervision) a statement briefly setting forth:

a. The location of the real estate or leasehold.

b. The number and total amount of securities issued under the mortgage or deed of trust,

and, if securities in addition to those actually issued are authorized to be issued under the mortgage or deed of trust, a statement of the total amount so authorized to be issued.

c. The amount of discounts, brokerage charges, fees (other than property insurance) and all other expenses incurred by the borrower in connection with the loan or charged for serving such loan, briefly itemized.

d. The assessed value of the underlying property as of the time of the issuance of the securities where the same is available, or, if not available, then the assessed value nearest to such date.

e. The aggregate taxes assessed against the underlying property for the latest year prior to the issuance of such security for which such assessment has been made, together with a statement of any special assessments that may have been made against such property but remain unpaid.

f. The amount for which the underlying property was appraised in connection with the mortgage or deed of trust, together with the name of the appraiser and a statement of his interest in or connection with the issuer, or, if not appraisal was made in such connection, the amount of any other appraisal known to the seller and the date and circumstances under which such appraisal was made.

g. The person or person (not including agents of such person) who examined the title and/or guaranteed such title.

h. The names of the trustees, if any, under the mortgage or deed of trust, and a statement as to their interest in or connection with, the issuer, if any.

i. The rights of the security holder, summarized, upon default in payment of the interest of any other payment required to be made under the terms of such security or the mortgage or deed of trust.

j. The nature of any retirement, sinking fund, or amortization provision.

k. The amount of the insurance outstanding upon the underlying property, its character, and the obligations of the mortgager to maintain such insurance.

l. The purposes for which the underlying property is used or is to be used, with a brief description of the nature of such property.

m. In the case of a construction mortgage, a statement to that effect together with a statement regarding the liability of the underlying security for prior mechanics', materialmens', and similar liens (the character and nature of which shall be briefly described), if any such liability may exist, and a statement as to the availability of funds to complete the structure.

n. In the case of a security guaranteed by a corporation other than the issuer, a summarized balance sheet of such corporation of a date not more than 90 days prior to the issuance of such security, which shall clearly set forth the contingent liabilities of such corporation.

III. — Securities comprising an issue which is exchange for other outstanding securities, whether or not a partial cash payment be also requested in connection with such exchange, which comply with the following conditions:

1. That the aggregate amount (being the capital amount or par value of the outstanding securities sought to be exchanged, or, if there be no capital amount or par value, the stated value of such securities) of the outstanding securities sought to be exchanged does not exceed $100,000.

2. That the issuer shall not within one year prior to the exchange herein sought to be effected have offered to exchange securities of an aggregate amount, as defined in paragraph (1) above, in excess of $100,000, inclusive of the securities herein exempted.

3. That although the security be accorded an exemption under this rule, no person offering such security for exchange shall be exempt from the liabilities imposed upon such person if the security were not so exempted, unless such person prior to the time of such offer of exchange shall give the holder the security to be exchanged (unless such holder be a financial institution or insurance company and be under state or federal supervision) a statement briefly setting forth:

a. In case the securities are called for deposit, a summary of the deposit agreement (which shall expressly set forth the provisions of the deposit agreement with respect to the circumstances under which the depositors will become bound by any plan of readjustment or reorganization and with respect to the rights of

holders of certificates of deposit to withdraw their securities and with respect to the terms and conditions upon which such rights may be exercised, including all charges therefor, and the general purpose of such charges) accompanied or followed by a summary of the plan for reorganization, stating therein specifically in both instances, so far as applicable in each instance, by whom the fees of the issuer and its members (including within such term a committee), its counsel, the reorganization managers and their counsel, and the depository are to be determined and out of what funds such charges are to be met and, if such fees are not to be determined by an independent person, making a specific statement to that effect, furnishing also, if available to the issuer, the last balance sheet and the last profit and loss statement of the issuer of the securities sought to be exchanged as published or reported generally to its security holders.

b. In case the securities are exchange without calling them for deposit, a summary of the terms upon which such exchange is sought to be effected, and if such issuer is other than an individual, furnishing also a balance sheet of the issuer of the securities sought to be exchanged not more than 90 days prior to the date of the original offering of the securities herein exempted, together with a profit and loss statement of the issuer of the securities sought to be exchanged for the latest year for which such statement is available.

REPEAL OF RULE OF JULY 27, 1933

The rule promulgated July 27, 1933, relating to notes and bonds secured by real estate mortgages, is repealed.